PROTECTING HOMEOWNERS: PREVENTING ABUSIVE LENDING WHILE PRESERVING ACCESS TO CREDIT

JOINT HEARING

BEFORE THE

SUBCOMMITTEE ON
FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

AND THE

SUBCOMMITTEE ON
HOUSING AND COMMUNITY OPPORTUNITY

OF THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED EIGHTH CONGRESS

FIRST SESSION

NOVEMBER 5, 2003

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CONTENTS

PROTECTING HOMEOWNERS: PREVENTING ABUSIVE LENDING WHILE PRESERVING ACCESS TO CREDIT

Wednesday, November 5, 2003

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
AND CONSUMER CREDIT,
AND
SUBCOMMITTEE ON HOUSING
AND COMMUNITY OPPORTUNITY,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittees met, pursuant to call, at 10:05 a.m., in Room 2128, Rayburn House Office Building, Hon. Robert W. Ney [chairman of the Subcommittee on Housing and Community Opportunity] presiding.

Present: Representatives Ney, Bachus, Baker, Royce, Kelly, Ose, Shays, Miller of California, Hart, Tiberi, Feeney, Hensarling, Garrett of New Jersey, Brown-Waite, Harris, Kanjorski, Waters, Sanders, Maloney, Velazquez, Watt, Ackerman, Sherman, Meeks, Lee, Moore, Ford, Hinojosa, Lucas, Crowley, Clay, Israel, McCarthy, Baca, Miller of North Carolina, Scott, and Davis.

Chairman NEY. The Subcommittee on Housing and Community Opportunity will come to order, and it is also the Subcommittee on Financial Institutions. We are doing a joint hearing. And I want to thank Congressman Bachus. I will begin, and then I will be leaving for a while, and Congressman Bachus is going to chair this. I appreciate his interest in this issue.

I also want to say, also off the bat, that there are a lot of members on this bill that—Congressman Lucas, my colleague, is the primary author of this bill, along with myself and other members. And I appreciate his willingness to tackle not only an important issue, but also a tough issue.

Protecting consumers from abusive lending and predatory practices is of great importance to everybody in our country. We all recognize that some unscrupulous lenders, using unfair and deceptive tactics, are costing Americans their homes and their livelihoods.

Because of a combination of misinformation and bad practices, some borrowers have been deceived into receiving a loan they really can't afford, while having the equity stripped out of their homes. This is wrong, and I know we all agree that it has to stop.

As we all know, the problem in stopping these bad practices is the difficulty in defining predatory lending. The Financial Services

Committee is challenged with preventing abusive lending without denying consumers access to credit. However, what might be good for one consumer might, frankly, be wrong for another. That leads us to today's hearing. I think that everyone in this room agrees that we must find a way to stop the practice of predatory lending.

For most Americans, much of their wealth is invested in their homes. To have this equity stripped out can be devastating for homeowners, especially the elderly who are relying on that equity for retirement security. However, the question before us is, how do you stop that which, frankly, I think is undefined.

Subprime lending is a legitimate and valuable part of our Nation's credit markets. Millions of Americans rely on subprime lending for everything from their children's education to health care. Placing onerous new restrictions on access to subprime credit will be devastating for consumers and our Nation's economy.

There are a number of ideas about how we can combat abusive lending practices. For example, earlier this year, as I mentioned, my good friend and colleague, Ken Lucas, and I introduced H.R. 833, which mixes new consumer protections with increased disclosure and consumer education initiatives.

I have also been working with other members, including Congressman David Scott, a member of our committee, and Congresswoman Nydia Velazquez to craft a homeownership counseling bill as a first step to educate consumers, combat abusive lending also. These bills are part of an ongoing discussion on predatory lending.

Throughout this year, I have been working on a bipartisan basis to foster discussion among the many interested parties about how we can balance competing views on the most effective solution to predatory lending. With the support of people like Chairman Bachus, whom I mentioned earlier, who has been instrumental in these efforts, we are trying to find a common ground with comprehensive solutions to the problem of abusive lending. I also appreciate the input of Chairman Oxley on these issues. This hearing is another important step in that process.

We brought together, I think, a very diverse group of people representing consumer groups, industry and academia to hear what they see as solutions to the problems of abusive lending. I want to have a fair and open dialogue today so that members of this committee can continue working towards a bipartisan solution that will protect consumers from abusive lending, while protecting their access to affordable credit.

And I think the idea I want to re-stress is a fair and open dialogue. A lot of people don't even want to discuss this subject, but we know what happened in some of our States, including Georgia, where the legislature had to come back and go through a lot of things because, frankly, a lot of people were shut out of the housing market, which is very unfortunate.

It is my personal belief that any potential legislation addressing the issue of abusive lending must address the growing patchwork of State and local predatory lending legislation. It must deal with the emerging problems of ascertaining liability.

That concludes my opening statement, and I will yield to Mr. Lucas.

Mr. LUCAS. Thank you, Mr. Chairman, Chairman Bachus. I appreciate you all holding this hearing today, and I would like to associate myself with the remarks that you just made.

I think the important thing here is that with my background prior to coming to Congress in banking and financial planning matters, I realized the importance of the issues that are facing us. HOEPA in its present form isn't working as well as it should.

And who is suffering from that? I think we are depriving people out there, who have less than perfect credit, of owning a home; and I look at my role. The reason I was willing to get involved in this legislation, which could be contentious, is that we need to improve on what we have now; and we need to keep the issues that are important with the consumer here, and also the people who are lending the money.

If we work together, we can make this better. And I think there is nothing cast in stone in 833; I think we are open and willing to listen to both sides as to what we might do to make this better.

And that is my purpose, if you will, to sort of be a referee and a person to work out the compromise so we can allow more people to have affordable housing at a reasonable price. Thank you.

Chairman NEY. I want to thank the gentleman for his support and his opening statement.

Chairman NEY. Chairman Bachus.

Chairman BACHUS. Thank you, Chairman Ney, for convening this joint hearing of our two subcommittees to review issues relating to the subprime mortgage lending industry in the United States.

This hearing, which is titled Protecting Homeowners: Preventing Abusive Lending While Preserving Access to Credit, will focus on ways to eliminate abusive lending practices in subprime lending markets, while preserving and promoting affordable lending to millions of Americans. This is an issue of critical importance to consumers, as well as the financial services industry; and I believe this hearing is a timely one.

Over the last decade or so, with low interest rates, a competitive marketplace, and various government policies encouraging homeownership, a record number of Americans have had the opportunity to purchase homes. A large number of these new homeowners have enjoyed one of the many benefits of homeownership, using the equity in their homes for home improvements, family emergencies, debt consolidation, and other reasons. Many of these consumers were able to purchase and use the equity in their homes because of the subprime lending market, which provides millions of Americans with credit that they may not have otherwise been able to obtain.

Many borrowers are unable to qualify for the lowest mortgage rate available in the prime market, also known as the conventional or conforming market, because they have less than perfect credit or cannot meet some of the tougher underwriting requirements of the prime market. These borrowers, who generally are considered as posing higher risk, rely on the subprime market which offers more customized mortgage protection to meet customers' varying credit needs and situations. Subprime borrowers pay higher rates and servicing costs to offset their greater risk.

Naturally, subprime mortgage originations have skyrocketed since the early 1990s. Financial companies, nonbank mortgage companies and, to a lesser extent, commercial banks have become active players in the arena. In 1994, just 34 billion in subprime mortgages were originated, compared with over 213 billion in 2002. In about 8 years, we have gone from 34 billion to 203 billion.

The proportion of subprime loans compared to all home loans has also risen dramatically. In 1994, subprime mortgages represented 5 percent of the overall mortgage originations in the United States. By 2002, the share had risen to 8.6 percent. Unfortunately, the increase in subprime lending has in some instances increased abusive lending practices that have been targeted at more vulnerable populations.

As Mr. Scott has said before this committee before, they target the vulnerable; minorities, the elderly are two of these targeted populations. These abusive practices have become known as predatory lending. Predatory loan features include excessively high interest rates and fees, balloon payments, high loan-to-value ratios, excessive prepayment penalties, loan flipping, loan steering, mandatory arbitration and unnecessary credit life insurance. Predatory lending has destroyed the dream of homeownership for many families while leaving behind devastated communities.

I hope today that we will move forward in developing ways to put an end to these harmful and deceptive practices while continuing to preserve and promote access for consumers to affordable credit.

In closing, I want to thank Chairman Ney and Congressman Ken Lucas for their tireless efforts on this issue over the past year. They are passionate about coming up with solutions and deserve a great deal of credit for all of their work. They have authored H.R. 833, the Responsible Lending Act.

I want to also commend Congressman David Scott for his work on H.R. 1865, the Prevention of Predatory Lending through Education Act. He and I have just come from a forum held at the Press Club, that the FDIC sponsored, where we talked about this legislation and other legislation promoting financial literacy and the importance of that in our overall effort.

I look forward to working with Chairman Ney, Congressman Lucas, Congressman Scott and with all of my other colleagues as we continue to examine this complicated issue.

I have made no decisions as far as particular provisions of legislation, what I will be supporting, what I won't be supporting. I think the purpose of this hearing is just the first step, at least in my mind, of seeing if we can come up with a meaningful and balanced bill.

Thank you, Chairman Ney.

Chairman NEY. Thank the gentleman.

[The prepared statement of Hon. Spencer Bachus can be found on page 76 in the appendix.]

Chairman NEY. Mr. Sanders.

Mr. SANDERS. Thank you, Mr. Chairman. And I thank you and Mr. Bachus for holding this important hearing. This is an issue that I think we are going to see more and more attention paid to, because I think all over this country not only in terms of home mortgages, but credit cards and other areas, people are getting sick and tired of being ripped off by companies and paying outrageous interest rates at a time when interest rates are historically low.

According to the Coalition for Responsible Lending, predatory lending is costing U.S. families over $9 billion every year. And I am pleased that George Brown with the Coalition is here today to discuss this national crisis.

Mr. Chairman, in the richest country on Earth, the record-breaking number of housing foreclosures in this country is a national disgrace. Between 1980 and 1999, both the number and the rate of home foreclosures in the U.S. Have skyrocketed by 277 percent.

According to an article in the New York Times, over 130,000 homes have been foreclosed in the spring of 2002 alone, with another record-breaking 414,000 foreclosures in the pipeline.

Many of these foreclosures are a direct result of predatory lending practices through a subprime market that must be put to an end immediately. In fact, according to the Mortgage Bankers Association, while subprime lenders account for 10 percent of the mortgage lending market, they account for 60 percent of foreclosures.

Predatory lending is a growing problem across the U.S. Desperate for homeownership or home improvements, more and more people are being tricked into home loans with high interest rates and fees that are impossible to pay, and eventually lead to foreclosure.

Predatory lending is being perpetrated by the likes of CitiGroup and Household International. As a result of legal actions filed by the Federal Trade Commission, CitiGroup agreed in September to reimburse consumers $215 million for predatory lending abuses, which represents the largest consumer settlement in FTC history.

Due to the good work of Iowa Attorney General Tom Miller, who is with us today—and we welcome you for being here—and other State Attorneys General, Household International has agreed to pay 484 million to reimburse victims of predatory lending, representing the largest direct payment ever in a State or Federal consumer case.

Homeownership is the American dream. It is the opportunity for all Americans to put down roots and start creating equity for themselves and their families. Homeownership has been the path to building wealth for generations of Americans. It has been the key to ensuring stable communities, good schools, safe streets.

Predatory lenders play on these hopes and dreams to rip people off and rob them of their homes. These lenders target lower income, elderly, and often unsophisticated homeowners for their abusive practices. What a lovely way to live one's life and run a business.

But let us not forget, when we are talking about predatory lending, we are not just talking about mortgage lending, as bad as that is. We are talking about auto financing and credit card companies as well.

Mr. Chairman, Mr. Bachus, I appreciate the opportunity to work with you against what I think is one of the most egregious predatory lending practices, the credit card interest rate bait-and-switch in which credit card companies double or triple the interest rates because a person is late on a student loan 3 years ago, or even maybe missed one credit card payment.

And mark my words, this is an issue that even the United States Congress will eventually begin to deal with because millions of people are tired of being ripped off not only by predatory lenders in mortgages, but by predatory lenders on credit cards as well.

We know of an instance where a person was paying 9 percent on their interest rates. Suddenly, they got a payment, and they were paying 14 percent. When asked what happened, when they made a call and asked what happened, the company said, Oh, you called us; we will bring it back to 9 percent, with the assumption that people who did not notice would be paying 14 percent. No reason, no late fees, no nothing.

So I think, Mr. Chairman, this is an issue in terms of mortgage rates which affects lots of people, but it goes beyond mortgage rates, and I look forward to working with you.

But I want to say one point. I am not in agreement that the United States Congress should preempt the ability of States to go forward. We have examples here in Iowa, North Carolina, and my own State of Vermont where governors, State legislatures, Attorneys General have stood up for consumers; and I think that in a nation which has 50 States we have got to respect the rights of those States to go forward. States are laboratories of democracy; and I do not agree with the trend that we are increasingly seeing from a quote, unquote, "conservative Congress" about taking away the ability of States to protect consumers.

So I feel strongly about that and look forward to working with you on that issue.

Chairman NEY. Before we proceed on, I would please note to members, today I am going to have to be very strict on the 5 minutes, because if everybody has a 5-minute opening statement, which is fine, we have got to get to the witnesses. So I will bang the gavel at the 5 minutes. Please try to observe the clock.

We will go on to Chairman Baker.

Mr. BAKER. Thank you very much, Mr. Chairman. I want to commend you and Mr. Bachus for your good work on the subject, and I commit to support the product that you two develop in this area of needed reform.

I will try to be brief and to the point. The only reason for my comment this morning is, having read through some of the testimony we are likely to receive here in the course of the hearing this morning, I am concerned by some of the recommendations that I have read with regard to the appropriate remedy.

Certainly individuals should have access to credit that is fair and balanced, priced for the risk that the extension of credit requires. Certainly the repayment terms should not be those which would lead to confiscatory practices, taking away the right to property by unreasonable repayment penalties. Certainly, individuals who find themselves affronted have access to some appellate process before they are thrown out of homeownership.

Having said all of that, all of us don't have the same credit. I find myself probably in the circumstance which a lot of people find themselves in, that you don't always get what you ask for in the way of extensions of credit. But the remedy to pricing risk is not to say that because there have been abusive practices, we should simply eliminate extensions of credit. Everybody needs access to credit.

Ultimately, at the end of the process, I hope that we can find a way to ferret out the wrongdoers, those who are victimizing the innocents who can't make the educated decisions they need to make for their own best financial interests; but at the same time, not preclude access to credit. If we close one lending window, the market is simply going to open another one somewhere else, and I suggest that the replacement window will be far more costly and bring about far more adverse consequences than a properly regulated mortgage industry.

So I stand in defense of the practice of extension of credit, priced on the risk which the lender assumes by making the money available in the first place. That is a good system. And where we can find wrongdoers that are engaging in practices not already in violation or Federal or State law, let's go get them. I will join with anyone in that effort and I do believe that that is an appropriate direction for us to take.

I again commend you, Mr. Chairman, for your leadership on this important subject, and yield back.

Chairman NEY. I want to thank the Chairman.

Chairman NEY. Mr. Scott of Georgia.

Mr. SCOTT. Thank you very much, Mr. Chairman. I appreciate it very much.

This is an extraordinary hearing on a monumental problem. It is a problem that we in Georgia have been grappling with for many years. I was very privileged as a State Senator in the Georgia general assembly many years ago, to tackle one of the most serious and the very first predatory lending cases to come before the Nation. As some of you may remember, it was the Fleet Finance situation.

We had a very broad usury law of 5 percent on the unpaid balance per month, which yielded out to 60 percent. And Fleet came down and took advantage of that and was charging up to 60 percent interest rates on second home mortgages. We moved to deal with that forthrightly.

We have wrestled with a lot of things. We have wrestled with trying to throw a net around the whole industry to catch that predatory lender. I found out some things. I found out, one important thing is that you have got to prepare for the storm before the hurricane is raging. An ounce of prevention is worth a pound of cure.

Education, I have found out, is the key. Because we—this is a targeted effort, the vulnerable among us are targeted, the uneducated are targeted, the African Americans are a target, Hispanics are a target, language barriers are a target. When we are dealing with high finances, just simply with home finances especially, it is a very complicated issue no matter what we put on the books as laws.

And we must put strong laws on the books; don't get me wrong about that. But I have found that where we are weak in this country is not having a strong vision of America that says we must have a financially literate nation. We are not there, and the pressure is on us to continue.

We are having a browning of America as I speak. Our growing populations are those populations of Hispanics and African Americans that are changing the complexion of this country. Education is needed here.

And so with that beginning, coming onto the financial services committee, I wanted to bring that kind of experience. We put a brokers licensing bill on. We recently in Georgia put the Georgia Fair Lending Practices Act on. And we went into an area of assigning liability that stretched just so far that we have come back in Georgia, we have had to go back and redo that because of the bonding requirements. Standard & Poor's would not back up those loans.

So where that brings us is to my initial point, that we must now look at financial literacy and financial education as a way to not solve all of the problems—I don't prescribe that this financial literacy is the panacea or the answer for all of the problem, but it is one of the most important components.

And I am very privileged and very delighted to have joined in with Chairman Ney and Chairman Oxley and Ranking Member Frank, Mr. Shays, Mr. Watt, Mr. Clay, Mr. Meeks, many of us who are very much concerned about arming our folks with the education that is needed.

And so we have put together a bill, which we call the Prevention of Predatory Lending Through Education Act. And, of course, realizing as a freshman Democrat that if we want to get something through, you have to partner, I am very proud to say that we have been successful in partnering this bill with Chairman Ney's bill, which we, of course, know will get through, as the ranking member and the Chairman of the subcommittee. It has been incorporated into a part of his overall housing counseling bill; I appreciate Chairman Ney for doing that.

Essentially, I would like to end by just telling you exactly what this bill would do. It would do four major things. One, we would provide grants to States and nonprofit agencies for programs that educate consumers, especially low-income borrowers and senior citizens about lending laws, counseling programs for homeowners and prospective homeowners, regarding unscrupulous lending practices and referral services for homeowners and prospective homeowners.

And secondly, which I think is the kernel of this law, it would create a nationwide toll-free number to receive consumer complaints regarding predatory lending practices, provide information about unscrupulous lending practices, refer victims to consumer protection agencies and organizations, and create a database of information for consumers.

I think that this 1-800 number is a help line. We can get that message out, target it to the most vulnerable groups. And one message, if nothing else, will be, Before you sign on the dotted line, call this 1-800 number. I think that kind of preventive medicine is what is needed.

Thirdly, it will coordinate government agencies and nonprofit organizations that provide education counseling to consumers who have been victims of predatory lending and practices to get those community organizations—the AARP, the NAACP, the grass-root groups who are interfacing on the front lines of this battle—to get them some grants to market the 1-800 number if nothing else.

And, thirdly, it would establish a predatory lending advisory council under the Department of Housing and Urban Development, comprised of community-based organizations, homeowners and government officials.

Thank you, Mr. Chairman.

Chairman NEY. Thank you. I appreciate your statement. In fact, the gentleman has pointed out he has been successful as a freshman Democrat. In fact, you are successful; I made you chairman of a subcommittee when I introduced you.

Mr. SCOTT. Thank you very much. I appreciate it.

Chairman NEY. Thank you. We will talk later.

And with that, I will move to the Vice Chair of the full committee, the Congresswoman from New York, Mrs. Kelly.

Mrs. KELLY. Thank you, Mr. Chairman. In the interest of time and because we have a large panel, I have no statement. Thank you for the time.

Chairman NEY. We will be moving to Mr. Hensarling.

Mr. HENSARLING. Thank you, Mr. Chairman. I certainly appreciate you and Chairman Bachus for holding this hearing. As I read the title of the hearing, " Protecting Homeowners, Preventing Abusive Lending While Preserving Access to Credit", I certainly hope that we don't lose focus on the second half of this phrase, "while preserving access to credit." .

If I did my homework properly, I believe that we are now in America enjoying the highest rate of homeownership in the history of the Republic. Those of us who sat through the many, many hearings on the Fair Credit Reporting Act heard witness after witness, testimony after testimony, testifying to the effect that we have the lowest cost of credit and the most available credit in the free world. We need to be very, very careful that we don't do anything that would harm this incredible proconsumer phenomenon or we ourselves may be guilty of abusive legislating.

As I read the staff memo, I also was interested to find out that what we call abusive practices, known as "predatory lending," we have yet to come to a consensus on exactly what that means. So I am looking forward to the testimony to find out what are these fraudulent, unfair, deceptive practices and what can we do to have a narrow, tailor-made remedy for them.

What I want to be careful about, though, and I certainly will not conclude that simply because one who controls credit decides to charge one customer a different interest rate, or another, offer him less generous terms, that that somehow is equivalent to predatory lending.

Also, I hope that we don't conclude that it is our mission to absolve borrowers of their individual responsibility. There is also a phenomenon out there that we should explore known as predatory borrowing, people who go out and borrow money and have no intention whatsoever of paying it back.

Those who control our own capital, who make it available for home mortgages should and must be able to price the cost of their credit based upon their assessment of the credit risk. It is called freedom and it leads to free enterprise. It leads to effective market competition, and that is indeed the consumer's best friend.

And certainly the mortgage lending business, as I observe it, gives all of the appearance of being a competitive marketplace. By unnecessarily restricting the terms by which legitimate lenders do business, credit lines can dry up. The cost of credit could go up 50 basis points, 75 basis points, maybe 2 percentage points, all leading to what I hope we want to avoid, and that is less credit opportunities, more expensive credit, and fewer Americans enjoying the dream of homeownership.

If I remember right, part of the physician's oath is to first do no harm. We need to make sure that, again, as we address a very serious problem, predatory lending, we come up with a very narrow and specifically tailored remedy to whatever definition we apply to predatory lending.

For example, if our Nation wanted to crack down on speeders, we could go out and we could confiscate every fourth car, put governors on the other engines to make sure that they never exceed 20 miles an hour. Unfortunately, that would be an affront to personal freedom and effectively outlaw driving as we know it.

By cracking down on predatory lending, which we must do, let's be careful that we do not effectively outlaw subprime lending and the hope of homeownership for millions of Americans.

I yield back the balance of my time.

Chairman NEY. I thank the gentleman.

Chairman NEY. Mr. Watt.

The gentleman yields to Ms. Velazquez from New York.

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

First, I want to thank Chairman Bachus and Chairman Ney for holding this hearing. The interaction between predatory lending and the subprime market is complex, and it is my hope that this hearing will help us move forward on this important issue.

Historically, homeownership has been a path leading to wealth and economic security for millions of American families. Today in the United States, one-half of all homeowners hold at least 50 percent of their net worth in home equity. This rate is even higher for minorities and low-income families. By building equity in their homes, families are able to send their children to college, start new businesses, or endure crises like job loss or illness.

For many Americans, it is sad to say that predatory lending is a threat to these possibilities. It forces families to declare bankruptcy because they cannot make payments for mortgages that shouldn't have been made in the first place. It rips them apart and leaves their financial futures and the futures of their children in jeopardy.

As we all know, predatory practices are nothing new, but they have become more widespread with the expansion of subprime home equity lending. Over the last decade, this market has grown dramatically, becoming a major source of revenue for lenders and an effective homeownership tool for borrowers.

This growth has attracted new lenders and mortgage brokers to the market. To many borrowers, a subprime loan provides an option they might not have had otherwise, because of poor credit histories or high existing debt. These loans permit these borrowers to refinance their existing loans or to consolidate other debts at better rates. As a result, these borrowers are able to save more of their money and increase their standard of living.

While subprime lending has been a great option for many borrowers, it has also led to more aggressive competition for loan volume; that, in turn, has provided greater incentive for deceptive lending practices. In recent years, States have moved to curb predatory lending by enacting legislation to prevent unscrupulous lenders from taking advantage of minorities, seniors and other vulnerable homeowners. But it is clear to me that we must balance the desire to retain States' and localities' rights to enact legislation with the need for an efficient Federal banking system that encourages the free flow of capital into those communities.

Beginning today, we will attempt to reduce the prevalence of predatory practices without negatively impacting the subprime market. I hope this will be the start of a longer debate that will lead to positive solutions on how to protect vulnerable and unsuspecting borrowers. Congress needs to move forward with a solution next year before millions more American families are victimized.

I look forward to continuing our work together on this issue. Thank you.

Chairman NEY. Thank you.

Chairman NEY. Mr. Garrett of New Jersey.

Mr. GARRETT OF NEW JERSEY. I yield back.

Chairman NEY. Mr. Royce of California.

Mr. ROYCE. Thank you, Mr. Chairman. I want to thank you and Chairman Bachus for holding this timely hearing on housing finance. And I would also like to thank our distinguished witnesses for appearing today. We look forward to their testimony.

I am very concerned, Mr. Chairman, that a number of States and a number of localities are increasingly creating laws and obstacles for firms trying to offer mortgages to customers in the nonprime market. And, in reality, these States are driving out responsible lenders and are leaving consumers in the nonprime market without very many options.

I am encouraged to see that there is a growing recognition by many of my colleagues that nonprime lenders are playing an important role in helping millions of Americans achieve the dream of homeownership, and I hope a solution can be found that enables responsible nonprime lenders to continue operating their businesses throughout the Nation. In my view, it is crucial that this committee does not place unnecessary burdens on responsible nonprime lenders, because in the end, that will only restrict consumer access to credit.

And once again I thank you, Chairman Ney, and I thank Chairman Bachus for having this hearing today. I look forward to working with my colleagues on this issue, and I yield back.

Chairman NEY. Thank the gentleman.

Chairman NEY. Also, a note to members: Without objection, all members' opening statements that they would like to make, if they want it for the record, will also be submitted for the record.

Mr. Watt.

Mr. WATT. Thank you, Mr. Chairman. I want to first thank you and Chairman Bachus for convening this important hearing and letting us get a start this year on thinking about these difficult issues. And they are difficult, especially at the center of the debate, around the perimeters of the debate.

I really don't know anybody, I have never heard anybody say that they liked predatory lending. But when you try to find the dividing line between prime and subprime and predatory, it can get to be a very difficult proposition.

So, in that sense, my comments are not far from where Mr. Baker's comments were, because we have to figure out what interest rates are a reflection of increased risk and what interest rates represent unfair or illegal opportunism or abuse. States and the Federal Government have been kind of wrestling with this problem, and I think will continue—some challenges that are very important to be worked out.

Some of the lenders in this area are not—do not have Federal regulators, and some of them do have direct Federal regulators. Some States have worked hard to address these problems in different ways. North Carolina seems to be taking the place of California in taking the lead on some of those issues and finding the right balance. But I remember that 2 or 3 or 4 years ago, when the North Carolina law was being debated, all of the lenders thought that it was the worst thing that could possibly happen to them. They subsequently came to realize that it was a pretty darn good balance, once they saw what Georgia did.

So this can be difficult. If we had federalized and preempted all State laws back in 1994 when we passed the Homeownership and Equity Protection Act, we now would know that that was not an appropriate floor, certainly not an appropriate ceiling, for every kind of situation.

So I am a little leery of the notion that we should be talking about preempting all State laws in this area, both because I think States have—have done a lot of work in this area. States regulate directly some of these lenders where Federal regulators are not responsible for them, and States, as Mr. Scott has said, can back up and go down another path a lot quicker than the Federal Government tends to be able to back up and go down another path.

So I think we have got some difficult work ahead trying to establish what the appropriate Federal role is, trying to establish what the appropriate Federal floor should be, and trying to establish that the States should continue to have leeway to set their own regulations, because they are closer to these lenders than we are.

Having said that, this hearing, I think, will help to set some of that groundwork and get us started thinking about these issues, because we have to roll up our sleeves next year and really come to grips with these difficult issues, which as I said around the edges are very easy if you call somebody a "predatory lender," but in a more defined context can be very difficult to resolve.

I thank the gentleman, and I yield back.

Chairman NEY. Thank you.

Chairman NEY. Mr. Miller of California.

Mr. MILLER OF CALIFORNIA. Thank you, Chairman Ney. Thank you for having this hearing today.

A lot of times people talk about subprime. When they do, they talk about extremely poor people or senior citizens or minorities, where in reality the majority of these people are 40 to 50 years old, incomes from $50- to $75,000 a year, and the majority of them are not minority.

But you have a group in this Nation whose credit rating is not what it should be. They have had problems with repayments, they have had problems in the past with certain issues, and they just don't qualify for the same rates and conditions of a person who has good credit and has a reliable source to repay a loan.

My concern is that we may do something to impact this subprime market that really hurts people who want to own their own home, and if it were not for the subprime market, they would not qualify under prime; and then they are forced to go into a market where they pay extremely excessive rates, if they can even get them, and they generally are put in a situation where they are not able to achieve homeownership.

It is pretty easy to look at the majority of predatory practices, excessive prepayment penalties, unfair pricing, steering people to higher-priced loans and virtually putting their equity in jeopardy, where they can really qualify for lower loans, financing points and fees through the loans.

There are certain things that predatory lenders do that you can separate them from a quality lender who is lending to subprime. And the last thing I know we want to do is to force people out of the marketplace. We are trying right now to get people out of government housing, trying to get them out of Section 8, trying to do everything we can to achieve the American dream, that is, own your home, so as the years grow and the time goes past, people have equity, they have wealth in their life all of a sudden, where they would not if they are renters.

And I think we need to move very carefully. I am looking at what some States have done trying to deal with subprime; they deal with mortgage originators and then they pass that same liability on to the secondary market for subprime. I think they are eliminating the option for people out there, because if there is no secondary market, if you don't get in with the prime, having to maintain that loan, you are going to deal with elimination of options available in the marketplace.

And so I really anxious to hear the testimony. I am looking forward to this hearing. I know the Chairman has a passion for this, as I do. Our goal is to make sure that we do everything that we can in the marketplace to create opportunity for people to become homeowners.

I yield back the balance of my time.

Chairman NEY. The gentlelady, Mrs. McCarthy of New York.

Mrs. MCCARTHY. Thank you, Mr. Chairman. I will submit my opening statement so we can go forward on the testimony. Thank you.

Chairman NEY. I thank the gentlelady.

Chairman NEY. The gentleman, Mr. Crowley of New York.

Mr. CROWLEY. Mr. Chairman, I thank you, Chairman Ney and Chairman Bachus, as well as Ranking Members Waters and Sanders for holding this joint committee hearing today on lending practices.

I hope that this will be the first of many hearings on lending issues, as there are a number of questions, a lot of misconceptions on the need for a Federal role to eliminate predatory lending as well as foster a climate for growth of subprime, or as I call them, "working family loans." .

Having seen the tripartisan way, Mr. Bachus, Mr. Sanders and this whole committee worked on FCRA, I am optimistic that this committee can craft a bill that all segments of our diverse caucus can rally around. One of the misconceptions out there is that this issue is a Republican issue, a rich banker's issue that—that to best protect our constituents, that we need to kill all lending outside of prime. And I strongly disagree with that premise.

The issue of subprime is a Democratic issue. With all due respect to my Republican colleagues, it is our constituents, whether they be in Queens, New York, South Central Los Angeles or Boston that will benefit by a tough Federal law that takes out the predators but encourages subprime lending. Our constituents are the working people with little credit history and, formerly, low to no availability of capital without subprime loans.

While many people look at some of the high-profile failures out there, like the predatory lending practices that no one supports—no one supports and should be banned outright, we need to refocus the discussion on the problem of the past, that of the situation of communities in the days prior to the availability of subprime lending. That problem was simple: no availability of capital in our communities, zero, none.

The truth is, subprime loans go to riskier borrowers. But if the subprime market dries up or is legislated out, we will return to the days of no capital flow in our districts.

I have talked a number of times with my neighboring Bronx colleague, Congressman Serrano, about the increasing homeownership rates over the past decade in the South Bronx, a community that we now share. You saw people with a work ethic and a desire to do better for themselves and their families, but with little capital, obtain loans to buy homes for $70,000 and turn that around into a nice profit in less than a decade, a real wealth creation in a very unlikely place. This is the success story of subprime.

For every horror story there are 20 success stories. While some would argue that subprime loans are giving money to people who cannot handle it, I don't buy that argument. According to National Geographic, I represent the most diverse community in the world in Elmhurst, Queens. It is bustling with small businesses and new homeowners, most of whom have no traditional experience with banks, no credit history and have to turn to the subprime market for loans. Without subprime, they would haven't gotten any capital, they wouldn't have the investments, the entrepreneurship, the wealth creation anyone can see on 74th Street in Jackson Heights and throughout my district.

This is a core Democratic issue of economic fairness and advancing capital to our constituents—Fairfield, Connecticut, has all of the capital they want; The Bronx doesn't—and it would be so adversely affected without subprime market in existence and—as we say, in the days before subprime. Good legislation can be crafted that can serve the interests of business and the consumers. That legislation will be written by Democrats for our constituents, and I hope to work with all sides in crafting this bill for our core constituencies.

Again, I commend you for holding this hearing today and yield back the balance of my time.

Chairman NEY. Thank the gentleman.

Chairman NEY. The gentlelady from Florida, Ms. Harris.

Ms. HARRIS. Thank you, Mr. Chairman. I wish to thank you and Chairman Bachus for holding this joint subcommittee meeting on this very important topic of subprime lending. I also want to thank our distinguished panelists for joining us today and for their testimony.

Consumer protection through disclosure has constituted a staple of Chairman Oxley's leadership of the Committee on Financial Services. Our discussions regarding this matter should remain consistent with this theme, and I believe that homeownership provides families and individuals with an unprecedented opportunity to create wealth.

Studies show that the average net worth of income of persons who are renting is about $900, yet it skyrockets to over $70,000 when they own their own home, thereby creating wealth and an asset that they can convey to their children and grandchildren. For most Americans, though, the ability to secure a mortgage is central to their ability to purchase a home, of course, and the damaged credit that has resulted from past mistakes or financial reversals can serve as a major obstacle thus, the willingness of certain industry institutions to underwrite the increased risk associated with the damaged-credit constituent constitutes an important service that provides a second chance for millions of people.

Regrettably, the abusive practices of bad actors that prey upon elderly and minority populations often has resulted in the demonization of an entire subprime industry.

Nevertheless, we can't ignore the effects of predatory lending if we truly seek to help nonconventional borrowers to overcome substandard credit. While I applaud industry and State-level initiatives to address unscrupulous lending practices, I contend that we must formulate a national policy that supplements and enhances these efforts. I look forward to the suggestions that today's panel will present, which I hope will provide us with a viable alternative for reforming the subprime industry without eliminating the critical borrowing opportunities that enable men, women and children to escape the grip of poverty.

Thank you.

Chairman NEY. The gentleman, Mr. Miller.

Mr. MILLER OF NORTH CAROLINA. Thank you, Mr. Chairman. I do not have an opening statement, as such, but I ask unanimous consent to make part of the record a 2003 study from the Center of Community Capitalism at the University of North Carolina, Chapel Hill, my alma mater.

The study is entitled The Impact of North Carolina's Antipredatory Lending Law: A Descriptive Analysis.

Mr. Chairman, Mr. Sanders describes the States as the laboratories of democracy. And my State, North Carolina, has been the leader on this issue, among the first, if not the first, State to pass legislation to address predation in lending practices. This study looks at the results of the North Carolina legislation.

It finds, in fact, that there was a decrease in the number of loans with predatory or abusive terms. Most of those were in not home purchase loans, but in refinancing loans, where the loans do not serve the purpose of realizing the dream of homeownership, but in fact caused people to lose their homes.

The result of the study was that there was—as to the effect on the cost of subprime credit, there was no increase in the cost of subprime credit; and as to the access to credit, there was no reduction in access to credit for high-risk borrowers. In fact, there was an increase in the number of purchase obligations, homeownership obligations.

So, Mr. Chairman, the result of this study suggests that we can do something to protect consumers from predation and not choke off any kind of access to credit to realize the dream of homeownership.

[The following information can be found on page 291 in the appendix.]

Chairman NEY. I thank the gentleman.

And at this point, I am assuming that our ranking member has nothing to say about this topic, and we will just move on to another member.

I am going to recognize the ranking member.

Ms. WATERS. Thank you very much, Chairman Ney. I certainly appreciate your allowing me to have a word to say about the subject.

Predatory lending involves a number of lending practices that target mostly minority communities, such as high interest rates and fees, unfair prepayment clauses, frequent refinancings that are not advantageous to consumers, and mandatory arbitration clauses. These lenders are able to engage in predatory activities because credit-starved communities—unfortunately, usually minorities and elderly persons—have little access to traditional sources of credit.

Of course, I recognize that not all subprime loans are predatory loans. However, the problems related to predatory lending do occur in the subprime market. These practices are prevalent in many areas across the country, and Federal action in this area is long overdue.

Predatory lending is the latest in a long line of practices that have targeted minorities and low- and moderate-income families, shutting them out of their American dream of homeownership. Both the lending terms and the manner in which predatory loans are solicited are problematic. Upon finding a likely target, oftentimes—for a predatory mortgage loan, the lender often resorts to high-pressure tactics to induce the homeowner to enter into the contract.

Contrary to what the industry wants you to believe, this problem is getting worse, not better. According to an Acorn study, African American homeowners who refinanced in the Los Angeles area were 2.5 times more likely to receive a subprime loan than white homeowners were, and Latinos were 1.5 times more likely to receive a subprime refinance loan.

Another Acorn study shows that subprime loans represented 26 percent of home purchase loans received by African Americans, and 20 percent of loans to Latinos, compared to only 7.5 percent of purchase loans to whites.

These predatory practices do not stop even if a minority is in an upper-income bracket. African Americans in upper-income neighborhoods are twice as likely to be in the subprime market as borrowers in low-income white neighborhoods.

Congress must be willing to go further and ask ourselves what can be done to fight these problems. We must scrutinize predatory lending practices and protect consumers who are targets for the predatory lending industry.

Enacting State laws, as California did, is a good start, but Congress and Federal agencies must recommit our efforts to ensure that greater opportunity to credit access means that all Americans will receive the credit opportunities they rightfully deserve. To this end, it is important that we not adopt national standards that would preempt strong State laws.

Lenders should not only participate in programs such as Fannie Mae's Timely Payment Rewards program, which permits subprime borrowers to qualify for interest rates that are lower than they would typically be and permits these borrowers to reduce their interest rates after timely payments. These lenders could be more creative with their own programs and reward subprime borrowers with better rates when they demonstrate creditworthiness.

We must continue to scrutinize predatory lending practices and protect American consumers who are easy targets for unscrupulous people in the subprime lending industry. We, as Members of Congress and Federal agencies, must recommit our efforts to ensure that greater opportunity to credit access means an increase in quality of life, not an increase in predatory lending and foreclosure.

I will certainly continue fighting on the Federal level until predatory lending is eliminated.

We will introduce new predatory lending bills next year directed at identifying predatory lenders and preventing them from targeting communities such as parts of the one that I represent in Los Angeles.

I encourage my colleagues to stand firm against predatory lending and look forward to working with you to eliminate this blight from our communities.

So I would like to thank you, Mr. Chairman, and I yield back the balance of my time.

Chairman NEY. I would like to thank our Ranking Member, the gentlelady from California.

The gentleman, Mr. Moore, of Kansas.

Mr. MOORE. Thank you, Mr. Chairman. I will be brief. I want to thank you for having this hearing. And I have listened to the other people who have already made an opening statement, and, frankly, most of what could be said has already been said.

And I just want to add that I practiced law for 28 years, and I learned a long time ago there are at least two sides to every issue and sometimes more. Certainly we are all interested, I hope, in protecting people from abusive lending, but also at the same time preserving access to credit for people, all people in this country.

And so I am looking forward to working with people who are on this panel as well as my colleagues in Congress, and I appreciate very much also the remarks made by Congressman Scott, and the effort towards financial literacy and protecting consumers through education is also very important. I look forward to working with all of you to get a good bill here. Thank you.

Chairman NEY. Thank you.

Chairman NEY. The gentleman, Mr. Clay, from Missouri.

Mr. CLAY. Thank you. Chairman Ney, I also want to thank Chairman Bachus for conducting the hearing, and I, too, will be brief.

Predatory lending is an unscrupulous and intolerable practice that destroys families and sullies the lending industry. The Federal Government has a responsibility both to consumers and to the financial institutions that offer legitimate subprime loans to enact responsible public policy, to put an end to predatory lending, and to ensure that households have access to fair subprime loans.

Too many families, many of which are among the most economically vulnerable in our society, have been abused and deceived by predatory lending. They have lost their homes and they have lost their dreams because they believed that they were engaging in sound financial practices.

There is no dispute that predatory lenders must be put out of business. Practices such as lending to borrowers without regard for the borrower's ability to repay the loan should be banned. Consumers should be provided with their credit scores so that they might better understand the risk they are assuming and they might make better informed decisions about accepting a subprime loan. Borrowers in the subprime market should be protected from excessive prepayment penalties that lead to unnecessary foreclosures, and lenders should recommend that subprime loan applicants seek and receive home mortgage counseling.

Too many victims of predatory lending lack information and knowledge about loans and the cost of financing. This information must be disclosed in a fair, simple, and uniform way in order to discourage and prevent predatory lending schemes and to reduce the number of subprime loans that end in default.

Preventing predatory lending should not mean the end of subprime loans. Subprime loans should be available to those who genuinely understand the risk and responsibilities of these mortgage loans.

And I yield back the balance of my time, Mr. Chairman.

Chairman NEY. Mr. Hinojosa from Texas.

Mr. HINOJOSA. Thank you, Chairman Ney. I thank you and Chairman Bachus, Ranking Members Waters and Sanders for calling this joint hearing on the subprime mortgage lending industry in the United States. I have waited too long to pass up this opportunity to be able to express my thoughts.

I represent a congressional district in south Texas comprised mostly of Hispanic Americans, a district that is one of the poorest in the country and that suffers from a staggering 13 percent unemployment rate. I hasten to add that the unemployment rate was 21 percent when I first took office in 1997, and I am proud to have played a role in reducing that rate substantially.

I tell you this because my constituents, based on their ethnicity and the poverty rate in my district, statistically are the recipients of subprime loans. While they tend to make less money annually than most of their fellow citizens around this great country, they tend to have to pay more for their mortgage rates due to predatory lenders, higher closing fees, higher interest rates or closing costs, which in some cases include required life insurance to pay off home mortgages.

So we are here today to discuss possible solutions both in the loan origination process and the secondary market for subprime mortgage loans to eliminate abusive mortgage lending practices. I think that all of us on the committee likely agree that loan-flipping rules need to be tightened to ensure that mortgages are not refinanced to a point where almost all the equity is stripped from the house. And I think that we can also agree that assignee liability must be adjusted as necessary.

One of the most difficult issues that we need to address today is the issue of preemption. Should we preempt State laws addressing subprime lending? Should we let the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the National Credit Union Administration decide this issue, or should we let the issue be resolved by the judicial branch?

I personally want everyone on this Committee and in this room to know how important this issue is to me and to my community. Let me assure you at this point that I understand the difference between a subprime and a predatory lender. The Hispanic community has been targeted and significantly wounded in the past by predatory lenders. However, some of these lenders have paid their fines, and they are trying to make amends.

Chairman Ney and Chairman Bachus, as we move forward on this issue of protecting homeowners, preventing abusive lending while preserving access to credit, including subprime lending, I hope we can continue to work on a bipartisan basis as you have allowed us to do today by having an equal number of witnesses selected by the Majority and by the Minority on each panel. It gives me a great feeling of pride to know that both sides of the aisle have been given an equal say on the makeup and the direction of this hearing. And with that, I yield back the balance of my time.

Chairman NEY. I thank the gentleman.

[The prepared statement of Hon. Rubén Hinojosa can be found on page 81 in the appendix.]

Chairman NEY. Mr. Ford.

Mr. FORD. I will be very brief, Chairman. Thank you. Thank you, Mr. Bachus, and to Ms. Waters and Mr. Sanders.

I join all of my colleagues in wanting to work with both Chairman Bachus and Chairman Ney to try to find a bill that in a lot of ways reconciles—I have read some of Mr. Brown's testimony and even my friend Steve Nadon's testimony and the rest of the testimony. I hope that we can work through in a way that will help us to actually bring light to the title of today's hearing, preventing abusive lending while preserving access to credit.

I was not here—forgive me for not being here, Mr. Chairman—when Mr. Watts spoke. I imagine he spoke eloquently about the importance of financial literacy. I can only hope at some point we here in this Congress will take a serious and meaningful look at how we might be able to introduce financial literacy classes into our education, particularly at a young age, at perhaps even elementary and at the middle school level.

All has been said that needs to be said on this issue in terms of curbing abusive lending practices, and I join my colleagues in wanting to do that. I also join those on this committee who have an open mind on the issue, who want to work through the differences that may exist and find a way to ensure that we can end the patchwork of laws, or I should say patchwork of issues, that lenders across the country or national lenders have to face going State by State.

With that being said, Mr. Chairman, I am happy to yield back the balance of my time.

Chairman NEY. I thank the gentleman.

Chairman NEY. Mr. Sherman of California.

Mr. SHERMAN. Thank you, Mr. Chairman and Ranking Members, for holding these hearings.

Subprime lenders are naturally the target of bad individual instances. After all, they make higher-risk loans on worst terms than those available to those with perfect credit. And then sometimes they go badly, and you find a need to foreclose.

What doesn't happen is a focus of congressional hearings on the 19 out of 20 or the 95 out of 100 who, in the absence of a subprime loan, would not be able to obtain or retain their home. Subprime lending is important even if it is hard to picture what would happen without it.

We need to provide, I think, national standards. The consumer will benefit from the fairness and protection of good protective efforts to prevent predatory lending. And there is a tendency for those of us who focus on consumer rights to think that every consumer protection, no matter how numerous, no matter how intricate, no matter how many different versions in the 50 States and one each for the cities of Santa Monica, West Hollywood, and Berkeley, not to mention a few other cities, should be adopted, and more consumer protection means consumers are more protected, when, in fact, that kind of intricate consumer protection means that we give up the efficiency and the competition that also benefits consumers. The idea that all of the industry is all fighting for an opportunity to make loans, while annoying to those of us who watch television and see your ceaseless commercials, shows that there is competition for the opportunity to make these loans even to those without perfect credit.

It was suggested by one of my colleagues that one of the possible ways that this gets resolved is in the judicial branch. I can't think of a worse thing for either lenders or borrowers, although that is what is happening now. That is to say, you get a highly complex and unclear series of statutes at all the various States and localities, and then trial lawyers looking for an opportunity to find either a substantial or an almost frivolous violation. And I would hope that, instead, we would have clear and strong consumer protections and without draconian penalties for the most technical of violations. But hopefully with clear standards there won't be any unintentional technical violations.

But in our effort to have national standards, we should not sink to the lowest common denominator. I will evaluate bills based upon whether the average American is getting more protection, and that means that in some areas, some local statutes that I like may be preempted, but that will be the cost of providing protection to places and communities and Americans that are not getting any protection at all.

I note that Representatives Ney and Lucas have introduced the Responsible Lending Act. This is a good step forward. It is not a perfect solution. That is why we have a very large committee to look at that proposal provision by provision.

So I look forward to preemption not as a step down, but as a step up in the average amount of consumer protection provided to Americans, and at the same time enhancing the amount of competition and the amount of efficiency that national lenders can provide to consumers.

I yield back.

Chairman NEY. I thank the gentleman.

Chairman NEY. Ms. Lee from California.

Ms. LEE. Thank you, Mr. Chairman. I also want to thank you and our Ranking Member Maxine Waters for holding this hearing; and also just mention that my community also is faced with the issue of predatory lending. In fact, this is one of the most important issues in northern California. So I am pleased that we are discussing this today. It is really time for this committee to turn its attention to this issue and work together towards eliminating these very abusive and what really should be, I think, illegal practices.

I also believe that national standards should be the floor, not the ceiling, and we should not in any way preempt local laws or State laws that really are working.

Senior citizens, one population of people, are especially vulnerable to these what I really call loan sharks. And I think it is about time that we make sure that we look at efforts to protect our senior citizens and their hard-earned resources that they have put into their homes, and not subject them to these varied abusive and illegal practices.

So I thank the Chairman for this hearing. I look forward to the testimony, and I yield back the balance of my time.

Chairman NEY. I thank the gentlelady.

Chairman NEY. Mr. Baca from California.

Mr. BACA. Thank you very much, Mr. Chairman, for allowing me to say a few words. I know that I am not a member of this committee, but I appreciate the joint hearing and your leadership and our Ranking Member Maxine Waters, who has always been an outstanding spokesperson for minorities and the disadvantaged throughout her time.

First, let me thank all the panelists for appearing here today. I look forward to hearing your testimony on issues that are very important to the Hispanic community and low-income community, and to many of my constituents in San Bernardino County, where our Chairman has his mother that lives in that area, in Fontana.

The issue today is predatory lending. Between 1995 and the year 2000, Hispanics accounted for about 16.3 percent of new owner-occupied homes. Today, there are over 4 million Hispanic homeowners throughout the Nation. The subprime market plays an important role in increasing the access to home ownership for Hispanics, especially for those with inconsistent credit history. Hispanic families remain 76 percent more likely to receive a subprime mortgage loan than white families. That is why predatory lending practices that often occur in subprime lending industries are so troubling, as indicated; illegal practices.

Our committees in Congress must look at protecting all consumers from such abusive lending practices. That means helping consumers learn how to protect themselves through effective—and I state through effective financial literacy programs and making substantive changes in HOEPA, but we must be careful to do so without adversely affecting the ability of minorities and others to receive affordable credit.

Again, I look forward to hearing your testimony and learning more about these important issues.

Thank you very much, Mr. Chairman, for having me join here.

Chairman NEY. I thank the gentleman.

Chairman NEY. Are there any other Members who have an opening statement?

I want to thank the panel for your patience and indulgence, but I think you can see from the amount of people that showed up and the amount of opening statements, that people have a passion for this issue, and it is important for all the Members to have their say as this opens and begins.

Again, I want to thank Chairman Bachus for chairing this with me. And we will begin with the first witness to be introduced by Chairman Bachus.

Chairman BACHUS. I thank the Chairman.

I would first like to reiterate what you said. The broad interest in the subject, I think, tells us we are all concerned about predatory lending practices, and we also realize the importance of the subprime market.

We have got an outstanding first panel. Mr. Pickel, welcome back. You were here just a few months ago testifying. Welcome, all of you.

It is my privilege to introduce a fellow Alabamian. Rob Couch is the Chairman of the Mortgage Bankers Association. Before I read his resume, I thought he was just a typical good old Alabama good old boy; although he headed up an institution, collateral mortgage, which is in New South Federal Savings Bank, which is the largest thrift in Alabama, a-billion-and-a-half-dollar institution. What I did know about Rob is that he graduated magna cum laude and summa cum laude from Washington and Lee, and that he clerked for Lewis Powell, an associate judge of the Supreme Court. So he has both practical and intellectual abilities. And I appreciate your testimony before the committee, and welcome.

Mr. COUCH. Thank you, Congressman.

Chairman NEY. If you can yield for a second, we are going to introduce the rest of the panel. Also, I have to leave for 15 or 20 some minutes. So it is not that you are starting and I am leaving; I have a meeting that I cannot get out of in the Capitol, and Congressman Bachus will chair.

Let me introduce the rest of the panel, and we will begin.

Also, A.W. Pickel is the President of the National Association of Mortgage Brokers, and the President of Leader Mortgage Company and Mortgage Banker Broker Company headquartered in Lenexa, Kansas. The Kansas Association Mortgage Brokers named Mr. Pickel Broker of the Year in 1999.

Allen Fishbein is the Director of Housing and Credit Policy with the Consumer Federation of America. The federation's membership includes more than 285 organizations throughout the country with a combined membership exceeding 50 million people. Before joining the federation, Mr. Fishbein was the general counsel for the Center for Community Change, where he specialized in issues pertaining to the expansion of responsible lending and banking services for low-income households and communities.

Mr. George Brown is the senior vice President of Self Help, a community development financial institution dedicated to helping low-income borrowers to buy homes and build businesses. Today Mr. Brown is also representing the Coalition for Responsible Lending, a group of over 80 organizations and 120 financial institutions. The coalition was formed in response to the large number of abusive home loans that threaten vulnerable residents of North Carolina.

Also, Mr. Thomas Miller is the Attorney General of the State of Iowa. He is serving his sixth 4-year term, having been elected in 1978. Mr. Miller has served continuously as Attorney General for over 25 years except for one 4-year period when he was in private practice as a partner of the Des Moines office of Fergrey and Benston law firm.

And the last panelist is Steven Nadon. He is Chief Operating Officer for the Irvine, California-based Option One Mortgage Corporation, a subsidiary of H&H Block, Incorporated. In this role he oversees the company's origination business as well as the internal lending operations. He has more than 25 years of experience in mortgage banking, real estate and financial services.

And, of course, Congressman Bachus introduced Mr. Couch.

With that, we will begin. Thank you.

STATEMENT OF ROBERT C. COUCH, CHAIRMAN, MORTGAGE BANKERS ASSOCIATION

Mr. COUCH. Thank you, Congressman.

Good morning. Today I speak to you in my capacity as the Chairman of the Mortgage Bankers Association. On behalf of our 2,700 member companies, I want to thank you for giving us the opportunity to share our views.

I first want to applaud your foresight in addressing this issue and including us in this discussion. The mortgage banking industry is vital to the Nation's economy. We provide the capital that makes it possible for families to build, own, or rent their homes. Our commitment to creating new financing tools has helped to create and sustain the recent historic surge in home ownership. Today more than two out of every three American families own the homes in which they live. The vitality of the housing finance sector has been a critical pillar of our economy.

I also want to make it clear up front that the Mortgage Bankers Association denounces abusive lending practices in the strongest possible terms. Abusive lenders hurt not only borrowers, but also the vast majority of ethical and reputable lenders. We believe that to achieve real, long-lasting solutions to the predatory lending problem, however, we must concentrate on three areas: First, by devoting more resources to aggressive enforcement of the existing consumer protection laws; second, by expanding consumer education; and finally, by simplifying the complex mortgage loan process.

The best defense against unscrupulous lenders is an educated consumer operating in a competitive marketplace. Nothing short of that will suffice. I am here today, however, to share NBA's concerns with the proliferation of State and local laws that are meant to address abusive lending.

In recent years the mortgage banking industry has greatly expanded its efforts to reach families who traditionally lacked access to credit. Many innovative credit options have made it possible for millions of low- and moderate-income families to build their family's wealth through home ownership. In 2001, for example, minorities accounted for about 32 percent of first-time home buyers, up from only 19 percent as recently as 1993. The Federal Reserve Board's Governor Gramlich calls this a true democratization of credit. These achievements did not occur by happenstance, but as the result of many years of industry advancement and market innovation.

As we explore the possible solutions to the problems of predatory lending, we need to understand the structure of today's mortgage industry. Mr. Chairman and members of the committee, it is not your father's credit market anymore. Most home buyers don't borrow their mortgage money from the reserves and deposits at their local savings and loans. Today we have a massive nationwide secondary market that purchases home secured loans and provides the capital for the most efficient mortgage system with the lowest rates in the entire world.

By our estimates, in 2002 over 75 percent of all U.S. residential mortgages were converted into securities, securities that usually find their way into the secondary mortgage markets. This is an astounding number. But there is one crucial ingredient for this national market to function well: Those involved in the market must be able to efficiently transfer capital across all regions of the United States.

Unfortunately, this crucial ingredient is under attack today. In their zeal to protect our more vulnerable consumers, State and local governments are passing far-reaching laws that are creating a confusing and fragmented mortgage market. Over the past 3 years, more than 28 States have enacted different antipredatory lending laws, and there are a myriad of additional bills pending as we speak.

We have already begun to see examples of how this muddled patchwork of laws has scared away reputable lenders, stifling the flow of capital to many deserving communities. We must stop abusive lending, but we should not throw the baby out with the bathwater. We must protect the efficiency of this finely tuned enormously productive national system as well.

Industry participants are in agreement; we need a national single standard that will bring order to the bewildering fragmentation of our mortgage market.

I also want to warn against a disturbing trend toward the confusion of subprime lending with predatory lending. The so-called subprime market serves a group of borrowers who would otherwise have little or no access to credit. This is a good and important service. We can make loans to these consumers through innovative financing options that were not available as recently as 20 years ago. This is an important point, because in the end these laws will hurt those consumers who most need the hand up that access to innovative credit can give.

Thank you for the opportunity to appear before the committee. I look forward to answering your questions.

Chairman BACHUS. [Presiding] Thank you.

[The prepared statement of Robert C. Couch can be found on page 101 in the appendix.]

Chairman BACHUS. Mr. Pickel. And what we are going to—and Mr. Couch did a good job of it—to actually try to restrict yourselves to the 5 minutes. I have been advised that the hearing has to wrap up at 1:30, and I think we have a second panel, so we are going to try to hurry this along.

STATEMENT OF A.W. PICKEL, III, PRESIDENT, NATIONAL ASSOCIATION OF MORTGAGE BROKERS

Mr. PICKEL. Good morning, Chairman Bachus and other members of the committee. I am A.W. Pickel, as I was introduced, President of the National Association of Mortgage Brokers, and President of my own company, Leader Mortgage Company in Lenexa, Kansas.

Thank you for inviting NAMB to testify today on issues surrounding abusive lending practices and the importance of protecting future and current homeowners in America. NAMB is the Nation's largest organization exclusively representing the interests of the mortgage brokerage industry and has more than 16,000 members and 46 State affiliates. Mortgage brokers spend a significant amount of our time with consumers so that they have a better understanding of each step of the home buying process.

I want to commend all of you for your leadership on this issue, as NAMB believes that discussing these issues is the key to prevention and abusive lending tactics. I also want to thank you for including NAMB in the series of predatory lending roundtable discussions that you have held over the past few months. We appreciate your continued efforts to provide a forum in which interested parties can discuss these issues in an effort to protect consumers.

Abusive lending practices strip borrowers of home equity and threaten families with foreclosure, therefore, destabilizing communities. That is not good. NAMB seeks to rid the industry of any unscrupulous actors that prey on vulnerable homeowners. We support efforts to expose abusive lending practices and combat abusive tactics. These efforts cannot, however, cut off consumer credit access or inhibit the mortgage finance industry from working with consumers throughout the home-buying process.

NAMB believes that some of the barriers to fair lending include addressing the lack of consumer financial education, insufficient enforcement of existing laws, and the need for industry self-regulation.

Since mortgage brokers originate more than 65 percent of all mortgages in this country, brokers are in a unique position to provide education about home ownership to consumers. Earlier this year, NAMB introduced a new consumer education program called "Are You Prepared to Head Down the Road to Home Ownership?" This program provides potential home buyers from inner city and urban populations with basic information to help them make informed choices and to avoid abusive lending tactics when buying a home. Our NAMB Web site also provides consumers with information on the mortgage process, including completing applications, down payments, refinancing, loan programs, and many other mortgage-related issues. NAMB also supports the many industry efforts and congressional efforts to address financial literacy among consumers.

On the issue of enforcement, State and Federal regulators should better enforce existing laws as a way to eliminate a great deal of abusive lending practices. The mortgage industry is heavily regulated now by Federal fair lending, consumer protection, and fraud laws, but the perpetrators often ignore these laws and go unpunished for their violations. This current lack of enforcement creates an environment that abusive lenders continue to cultivate, and therefore victimize consumers. NAMB believes that industry self-regulation can play an integral role in efforts to combat abusive lending practices. We believe residential loan originators who work directly with home buyers should be educated, honest, and nothing short of professional.

In 2002, NAMB introduced its Model State Statute initiative on licensing, prelicensure education, and continuing education requirements to protect consumers and ensure originator competency. Throughout this effort, NAMB seeks to have individual State statutes enacted that require prelicensure education, background checks, and to mandate continuing education requirements for all residential loan originators in an effort to protect consumers. NAMB believes that such an initiative will serve to help reduce the incidents of abusive lending and improve the overall competency of the industry.

NAMB is also leading an industry effort to create a nationwide registry of all mortgage originators and companies. NAMB supports a Federal registry of all loan originators. We believe a nationwide registry will give mortgage industry professionals an avenue to report unscrupulous actions by other professionals and help to police itself and eliminate bad actors from its ranks. Also, as a requirement of NAMB membership, all members—our members subscribe to NAMB's Best Lending Practices Guidelines and NAMB's Code of Ethics.

I would like to briefly touch on the issue of subprime lending. There has been widespread confusion as to the term "subprime" and "predatory," as many reports of unfair lending are alleged to have come from subprime loans.

Subprime loans are offered to consumers with a credit history that would not permit them to qualify for the conventional loan market. The great majority of subprime lending today results in benefits to consumers at reasonable, appropriate risk-based prices for consumers who may have no other option to credit. Efforts to address abusive lending tactics must be carefully considered so as not to completely restrict these homeowners from getting the loans they want for the homes they have or they need.

In conclusion, I do want to say that NAMB is deeply troubled by the continued reports of abusive lending practices in the mortgage industry, but combating abuse calls for a comprehensive strategy, one that employs the most effective tools available to the regulatory, legal, and educational communities. All participants in the lending community must maintain the integrity of our credit system and thwart participants that do not honor these systems.

Thank you for the opportunity to testify. I will be happy to answer any questions that you might have.

Chairman BACHUS. Thank you.

[The prepared statement of A.W. Pickel III can be found on page 212 in the appendix.]

Chairman BACHUS. Mr. Fishbein.

STATEMENT OF ALLEN J. FISHBEIN, DIRECTOR OF HOUSING AND CREDIT POLICY, CONSUMER FEDERATION OF AMERICA

Mr. FISHBEIN. Good morning, Chairman Bachus and Chairman Ney and Ranking Members Sanders and Waters. It is a pleasure to be here, and we appreciate the invitation you extended to Consumer Federation to participate in these important hearings.

As you noted, CFA is a national federation of some 300 consumer groups that works on behalf of the consumer interest and represents over 50 million people.

Predatory lending, exploitive lending to financially unsophisticated borrowers, occurs in all aspects of consumer credit, such as auto finance, credit cards, and short-term installment debt. However, the explosive growth of predatory and abusive practices in mortgage lending has deservedly received much attention in recent years. This is understandable. Home ownership is the single most important instrument used by Americans to build wealth. However, the positive contributions of the home mortgage finance market are undermined when home owners are lured into loans with terms that are not beneficial to them, often as the result of abusive practices by so-called predatory lenders.

Predatory lending has been a disturbing part of the growth in the subprime component of the conventional mortgage market which has grown substantially over the past decade. It has been estimated that borrowers lose about 9.1 billion dollars annually to predatory lending practices. And further, while home ownership nationwide has reached record levels, research indicates that subprime loans—the subprime loan market in combination with predatory practices—are contributing to a record high home foreclosure rate.

My testimony focuses on four areas that should be of concern to members of both subcommittees, and helps explain why predatory lending has become a serious national problem, and I will just summarize them here.

First, there has been a tremendous transformation in the structure and operation of mortgage lending; whereas once mortgages were mostly made by deposit-taking institutions, today most mortgage lending is conducted by nonbank financial institutions. Whereas in the past more rigorous regulatory oversight and consumer protections were in place for these deposit-taking institutions, changes in the law have not kept pace with changes in the marketplace. Nonbank institutions are less supervised than depository lenders, not subject to regular on-site examinations, for example, and as a result the nonbank lending oversight is largely complaint-driven. So the burden has fallen on the consumer to try to foster compliance.

This has opened up opportunities for abusive practices to occur merely because they are less likely to be detected. This is certainly not to suggest that there aren't problems with predatory lending with banks and depository institutions, because these problems have been documented, and they also include problems with the affiliates and subsidiaries of banking institutions as well.

The second key point I make in my testimony is about the emergence of a dual mortgage delivery system, one for prime borrowers with particular products for them largely focused on middle- and upper-income households, and another one specializing in subprime, government-insured and manufactured housing, which is largely directed to low-income and minority communities.

Third, as a result of these changes in the delivery system, subprime lending is disproportionately concentrated to minorities and to low-income households and communities. This is particularly true for the home refinance market. One study I cite in my testimony found that while 25 percent of home refinancings were subprime, this figure jumped to 50 percent for African American households and over 30 percent for Hispanics. The study also found that these disparities increased—which is counterintuitive—with income, so that for higher-income African Americans and higher-income Hispanics, the disparities are actually larger than they are for low-income segments of the market, resulting in the fact that upper-income African Americans are more likely to have a subprime loan than lower-income whites.

The differences in these disparities are not explained by risk alone. Certainly the research suggests that. One of the key factors is the absence of mainstream lenders in this home refinance market in many areas. And as a result, research suggests that a significant number of subprime loans are made to borrowers who would qualify for cheaper loans. For example, Fannie Mae found that up to 50 percent of borrowers in the subprime market could qualify for cheaper loans. And other research suggests that the subprime market is not as efficient as it can be, and some borrowers are paying more than the credit profile would otherwise indicate, which is an example of opportunistic and inefficient pricing that is existing in the subprime market.

The fourth point is that high rates of subprime foreclosures should be of particular concern because they are so concentrated, and they can have devastating neighborhood effects. High foreclosure rates for subprime loans may also be an indication of the "smoking gun" of predatory lending. Nationally between one out of every five and one out of eight subprime loans is seriously delinquent and in foreclosure, and in States like Ohio the subprime foreclosure rate could be 12 times higher than it is for prime lending. This is disturbing because in these situations it harms not only the individuals, but it can have a destructive effect on whole neighborhoods. This subprime foreclosure wave could be very similar to the wave of FHA foreclosure we saw in the 1960s, which destroyed too many communities.

The smoking gun——

Chairman BACHUS. Mr. Fishbein, if you could.

Mr. FISHBEIN. I will just conclude by saying that subprime lending may be the smoking gun of predatory lending. We find that subprime loans go into default much more quickly, as little as 1-1/2 years after they have been made, suggesting that these loans were not affordable at the time they were made.

And I will just conclude by saying that existing law is not adequate to correct all these problems, and that we need improvements to existing Federal law, not the least of which would be tight restrictions on the financing of points and fees as well as other improvements to the Home Ownership and Equity Protection Act to reflect the conditions that exist in the current marketplace.

Thank you very much.

Chairman BACHUS. Thank you.

[The prepared statement of Alan Fishbein can be found on page 142 in the appendix.]

Chairman BACHUS. Mr. Brown.

STATEMENT OF GEORGE BROWN, SENIOR VICE PRESIDENT, SELF HELP, ON BEHALF OF NORTH CAROLINA COALITION FOR RESPONSIBLE LENDING

Mr. BROWN. Mr. Chairman, Chairman Bachus, Chairman Ney, and Ranking Member Waters, it is a pleasure to be here to discuss this problem of predatory mortgage lending. And I speak on behalf of Self Help and the Coalition for Responsible Lending, but I also speak with a deep personal conviction that predatory lending devastates communities and with great certainty that these organizations that I represent have an approach to the problem that is workable and fair.

As a nonprofit community development lender, Self Help is dedicated to helping low-wealth families buy homes, build businesses, and strengthen communities. Over the past 20 plus years, Self Help has provided over $3 billion in financing for some 35,000 families in 48 States. Despite the claims of many in the industry that our borrowers are so risky to serve or are too risky to serve without practices that are considered abusive, our overall loan loss rate is less than 1/2 of 1 percent per year, and our assets have grown to over $1 billion. We know that subprime lending can be done without being predatory.

The Coalition for Responsible Lending represents over 3 million people through 80 organizations as well as CEOs of 120 financial institutions formed in response to the large number of abusive home loans that threaten the most vulnerable members of our

North Carolina communities. The coalition spearheaded an effort in 1999 to enact market-based—let me repeat—market-based, common-sense State legislation to protect borrowers from predatory lending practices. This legislation passed almost unanimously and has been successful in protecting both borrowers and the vibrancy of the subprime lending market.

From the beginning, coalition members and the industry trade associations agreed on two fundamental principles: First, we would not rely on disclosures. In the blizzard of paper involved in home loan closings, even the well-educated borrower can fail to understand the fine print in documents they are signing. Second, we would not ration credit by attempting to cap interest rates. We believe that risk-based pricing—in fact, Self Help has done it since we created—since we started making subprime loans almost 20 years ago. Loans with higher risk should be paid for through higher interest rates, but not through exorbitant upfront fees or back-end prepayment penalties. With risk captured in the rate, a subsequent lender can always refinance a borrower out of a loan that no longer reflects that borrower's risk, if it ever did. No one can rescue a borrower from a loan that has been inflated through financing of exorbitant fees.

From these two principles came a fairly simple solution: Stop exorbitant fees, and encourage lender compensation to be reflected in interest rates.

Recent research clearly shows that North Carolina law is having its intended effect. Borrowers continue to have access to a wide variety of competitively priced loans from a wide variety of lenders. At the same time, creditor lending has declined significantly. It looks like the dirty water got out, but the baby lived.

The best research in North Carolina law was recently completed by the Center for Capitalism at the University of North Carolina in June of this year. Using the largest and most comprehensive available database, the UNC study found that subprime lending has continued to thrive in North Carolina after the passage of the law. In fact, subprime lending to borrowers with poor credit actually has increased by 31 percent, and subprime lending to buy a home increased by 43 percent. Surely the North Carolina law has not dried up credit.

The UNC study found that the North Carolina law, in addition to protecting access to capital and to credit, also protected borrowers from abusive loan terms. Prepayment penalties dropped by 72 percent, in stark contrast to nearby States. In addition, the research suggested that fewer borrowers are being steered to more expensive subprime loans when they could qualify for prime loans. Simply, put the North Carolina law is weeding out the bad loans while preserving the good.

While North Carolina was the first State in the Nation to pass strong antipredatory lending legislation, others have followed in the footsteps and have found new ways to address upfront fees and other abusive practices. In fact, just this year North Carolina learned from these States and amended its predatory lending law to include open-ended loans within its coverage.

States are in the best position to respond to the challenges presented by predatory lending for at least three reasons: First, many of the bad actors involved in predatory lending are State-chartered entities. Second, region evaluation in real estate markets requires different solutions to predatory lending. Loans in North Carolina may need different protections from those in Utah. Finally, irresponsible lenders can invent new abusive practices virtually overnight, and States can react much more quickly than the Federal Government to these changes.

We urge you, however, we urge you to partner with States and provide meaningful protection for the Nation's homeowners. Congress should make Federal text a floor upon which States can build instead of a ceiling beyond which no State can protect its own citizens from abuse.

In opposing a broad preemption, we stand alongside——

Chairman BACHUS. Mr. Brown, if you will wrap up.

Mr. BROWN. Will do—among all 50 States Attorney Generals and State bank supervisors. At the end of the day, this is federalism at its best. Whether legislature, lender, or advocate, we must stay focused on the important goal that we all share, creating a safe mortgage market for all American families to get to that American dream. Thank you.

Chairman BACHUS. Thank you, Mr. Brown.

[The prepared statement of George Brown can be found on page 83 in the appendix.]

Chairman BACHUS. And, Attorney General Miller, we welcome you.

STATEMENT OF THOMAS J. MILLER, ATTORNEY GENERAL, STATE OF IOWA

Mr. MILLER. Thank you, Mr. Chairman and Congresswoman Waters, members of the Committee. Thank you for inviting me on behalf of the Attorney Generals of America. This is a subject that I feel very strongly about, as do my colleagues, so it is a pleasure to be here. It is a special pleasure for me to look up to the wall there and see my friend and your former Chair Jim Leach looking down at me. In fact, his eyes almost seemed to be focused on me. I appreciate that.

I am going to make five points in my 5 minutes. The first one is a fundamental point. As you look at balancing availability of credit and prohibiting abusive practices, what you need to understand, what we all need to understand, is the difference between constructive credit and destructive credit. Constructive credit is what we are most familiar with in the prime market, and much of the subprime market as well, where people borrow money, they pay payments over a period of time, and their equity continues to grow. That is the American dream.

But there is also destructive credit, and that is really what we are talking about in major part in predatory lending. This is credit that strips the equity from the house. Instead of the equity going up, it goes down. And you need to target those practices. Some of those practices are balloon payments where the person keeps paying, but their equity doesn't go up, their net worth doesn't go up. Or, if it does, it is just so small that after 15 years they almost owe as much as before. Balloon payments. High loans to value loans, where they loan out 125 percent of the value of the property. Destructive credit. Flipping, where they refinance repeatedly over a short period of time and they go through points and charges three, four times. Destructive credit. Points that are way too high, and other fees, 5, 6, 7 percent. Destructive credit.

So what you really need to do is target at the margin the destructive credit practices and let constructive credit grow. Those are the parameters. And that is the lesson from North Carolina.

I want to join the chorus of those singing the praise of the North Carolina law. They targeted the practices that dealt with destructive credit. So what happened? The study from UNC, as Congressman Miller mentioned, demonstrates very well over a 4-year period purchase money, new purchase of homes, the value went up 43 percent over 4 years, which is exactly the same increase as the South generally.

Now, refinancing didn't go up quite as much. This is what you would expect if you successfully targeted destructive credit.

Incidentally, I visited with the CEO of Household Finance, and he told me initially they opposed the North Carolina law, but in reflection they thought it was working, they were lending more than before. They thought a few marginal players were no longer there, and we said that is the point, they were the ones involved in destructive credit.

My second point is that there is a lot of credit, there is a lot of money available in this market, and that is a good thing. Through the new way of scoring applicants and securitization this industry, including in the subprime market, has grown terrifically. So there is at least some margin of error as we try and target destructive credit.

My third point is to talk a little bit about dynamics here. This is an industry that has some unusual dynamics, as all industries do. First lending is done on a decentralized basis. There is loan offices throughout the country. It can't be managed from a national office; it is decentralized. Secondly, practically all of the people employed are involved in some sort of quota system or other incentive system. So they have got an incentive. And the third thing is they are dealing with a complex transition with a vulnerable population. So think about that. Little control from the national office, incentive system, a vulnerable population. Those are dynamics that can cause some serious problems and in some cases have.

Another way to look at this is opportunistic pricing. Every person that comes into one of those loan offices, they get scored at the national office. There is usually some sort of pyramid or a matrix that says this person with these characteristics qualifies for this loan at this percentage with this number of charges. The lender can figure that out. Then the question is, do they charge more than that? And if they do charge more than that, how much more? And how is it divided between the company and the employees of the branch office? Those are the dynamics that are being dealt with here.

My fourth point is that we are making some progress in this area. We have done the Household case, FTC has done the Associates case. The industry has done some good things. Household is reforming their system, and I think in a very constructive way. CitiFinancial has done some good things in bringing in Associates and cleaning them up. Ameriquest has told me recently that they don't charge opportunistic pricing. Whatever that person scores, whatever they should have on their grid system, that is the price they get charged.

And, finally, there is more awareness in the whole community about this problem, as you can tell that from the testimony. So, we are making some progress.

My final point is this, to you and the other policymakers in Washington, and this is my final and heartfelt point: Be consistent with the oath of a doctor. Do no harm. Harm is being done at the OCC by extensive preemption of State law and State law enforcement. And do no harm when you do your legislation in terms of preemption. The best thing we have got going now based on laboratories of democracy, as Congressman Watt and Congressman Miller said, and George Brown, the best thing we have going in this area is North Carolina, and that happened because the State experimented with it. Don't preempt the North Carolina law. Don't preempt other opportunities to solve this problem, because it is a complex, in some ways local, problem that no matter how brilliant you all are and your staffs and how long you sit around and try and figure out what the best solution, that can't compare with the experimentation in the States. Look at North Carolina. Please do no harm.

Chairman BACHUS. Thank you.

[The prepared statement of Hon. Thomas J. Miller can be found on page 159 in the appendix.]

Chairman BACHUS. Mr. Nadon.

STATEMENT OF STEVE NADON, CHIEF OPERATING OFFICER AND EXECUTIVE VICE PRESIDENT, OPTION ONE, ON BEHALF OF COALITION FOR FAIR AND AFFORDABLE LENDING

Mr. NADON. First, I appreciate the opportunity to testify today on behalf of the Coalition for Fair and Affordable Lending, which I chair. I want to commend Chairman Bachus and Chairman Ney and Ranking Member Waters for scheduling this hearing today.

Without question, some lenders and mortgage brokers engage in inappropriate lending practices that need to be stopped. Many of these abuses are fraudulent, deceptive, and are illegal. Enhanced enforcement, together with more consumer financial education and counseling opportunities, are needed to help prevent them. However, significant new Federal statutory requirements are also needed to improve gaps or weaknesses in current law.

CFAL believes that it is imperative that Congress promptly pass such new Federal requirements. H.R. 833, the Ney-Lucas bill, effectively addresses many of the current law's shortcomings. We urge Members to work together after this hearing to further refine H.R. 833 as may be needed to address any additional concerns and gain broader bipartisan support. We want to work constructively with you and other interested parties to help craft fair and balanced legislative proposals that can be the basis for new Federal law and that the full committee can act on it later next year.

The Home Ownership Equity Protection Act of 1994, as it is referred to as HOEPA, was enacted to provide additional disclosures and substantive protections for certain of the highest-cost mortgage loans. Unfortunately, as I explained in detail in my written testimony, HOEPA is seriously flawed. The advocates point out that it is inadequate for two reasons primarily: It applies to only a relatively small portion of the higher-cost loans; and, second, that it fails to mandate any substantive protections that are needed to prevent certain abusive practices.

The lenders acknowledge that HOEPA does not contain some restrictions that are needed to protect the borrowers from abusive practices. We also feel strongly that HOEPA is also fundamentally flawed because it includes unclear requirements, so lenders may not know what they are supposed to do; fails to provide a meaningful right to cure unintentional errors; mandates unduly severe penalties; and imposes liability on assignees who could not reasonably know of violations.

HOEPA has the practical effect of prohibiting borrowers from being able to obtain legitimate nonprime loans instead of simply restricting inappropriate practices. Few lenders make loans that are subject to this statute, and there are virtually no secondary market purchasers of the relatively few that are made. The HOEPA loans that are originated are held by portfolio lenders who are likely to charge an even higher price due not to the borrower's credit, but due to the higher legal and reputational risks and reduced competition caused by the law itself.

Despite its current weaknesses, CFAL believes that these problems can be solved. HOEPA can be amended to cover far more loans and provide significantly more protections. This can and must be done, however, in a reasonable and balanced manner so that lenders can continue to make nonprime credit available.

My written testimony suggests a number of specific conceptual suggestions for amendments, which include, one, covering more loans by including purchase money and open-end loans, otherwise known as home equity lines of credit; two, adding restrictions on prepayment penalties; three, further limiting balloon payment terms and prohibitions on single-premium credit life insurance and similar products; four, adopting a benefit test to prevent loan flipping; five, provide a meaningful right to cure unintentional violations; six is very tough language that would go after the bad actors who are intentionally violating the law; and, finally, enhancing consumer education and counseling, including helping with the State enforcement, which we think can be done by charging a fee to all lenders on the loans that are originated which can be put into some sort of an education or an enforcement fund.

Congress has failed to update HOEPA over the last several years, and not surprisingly, therefore, starting in 1999 with North Carolina, many States and localities have enacted or are seriously considering enacting on their own prohibitive language or laws on predatory lending. However, they are developing into an arbitrary and irrational patchwork of laws that are in some cases inadequate and in others unduly burdensome and costly. Moreover, federally chartered depositories as well as some State-chartered entities are being exempted from these State and local law requirements. This creates not only an unlevel regulatory playing field for lenders, but also confusion and inconsistent levels of protection for borrowers. Many consumers are not being adequately or equally protected by these measures. In addition, the national nonprime housing finance market is being disrupted.

As committee members know, housing is critically important to our Nation not only as home ownership, the American dream, and central to the welfare and stability of families and communities, it is vital for our Nation's economy. And nonprime mortgage lending is critically important for meeting the household housing credit needs of the millions of Americans who are unable to qualify for prime mortgage credit. This nonprime market last year amounted to approximately $213 billion, or about 10 percent of the overall mortgage market. Sixty-five percent of those loans were sold into the secondary market and ultimately securitized. Today one of the major reasons why the availability of nonprime credit has relatively low rates which average about 2 percent less than the prime rates is this securitization process.

Securitization has provided capital from the national/international markets to fund these higher-risk loans. This has made mortgage credit much more available and dramatically decreased cost to borrowers.

The developing patchwork of State and local laws is seriously hindering lenders' abilities to continue providing nonprime mortgage credit that borrowers want and need. We have seen the effects of overreaching restrictions earlier after the nonprime lending market shut down in Georgia due to excessive restrictions in its lending law. We are now starting to see the same market disruption in New Jersey, Los Angeles, and Oakland for the same reasons.

We ask that you work on a bipartisan basis to promptly develop balanced and workable new Federal responsible lending rules and make them apply uniformly so that all mortgage lenders are governed by them and that every American borrower receives the same effective protections.

In closing, let me note that I think the American people are supportive of Congress acting as we suggested, as evidenced by a new poll that CFAL is releasing today. A press release describing the poll's findings is attached for your information.

Finally, I want to emphasize that CFAL's members are flexible, we are very open to compromise and in developing a further refined bipartisan proposal. We really look forward to working with everyone on both sides of the aisle and with yourselves and the consumer groups to find a final solution on this.

Chairman BACHUS. Thank you.

[The prepared statement of Steve Nadon can be found on page 193 in the appendix.]

Chairman BACHUS. Let me start out by asking this: We have talked about OCC and OTS and preemption and the North Carolina law. Does North Carolina law, as I understand it, only apply to finance companies? It doesn't apply to national banks or to banks? What is it?

Mr. BROWN. Mr. Chairman, the North Carolina law was a law that was a consensus document, that was a consensus of all of the major banking operations in the State of North Carolina. And so the law sought to deal with a lot of the State-chartered entities such as the finance companies, but the law is quite pervasive. And the individual, both on the finance side as well as the lenders, the major depository lenders, have also been a part of the regulations of the North Carolina law.

Chairman BACHUS. So the North Carolina law applies to your depository institution?

Mr. BROWN. Well, it applies—it is focused principally on those State-chartered entities and finance—finance companies, but the coalition and the consensus of the local State bankers association, the mortgage bankers associations, et cetera, have essentially signed on to this legislation, to also follow the rules and the guidance and the guideposts of the legislation.

Mr. MILLER. Mr. Chairman, I have just been in court; I hope you are not insulted by calling you, Your Honor. I would just add that in North Carolina, some of the best things about democracy, serious problems addressed in a bipartisan way, addressed with the whole industry—practically the whole industry, including the banking industry, in and on a solution, and agreed to by most everybody, and, as we can tell, is working as well or better than anything else in the country.

Chairman BACHUS. Okay.

Chairman BACHUS. You know, you all's testimony has mentioned that many of the abusive practices are already illegal. What can Congress do, say, to enhance the enforcement of the existing law to help stop predatory lending?

And, Attorney General Miller, you mentioned loan flipping. And, in that regard, I understand a lot of unscrupulous brokers and lenders, to avoid the flipping restrictions, they simply modify the terms. So could we address that problem maybe by restricting modifications or either deferral fees on HOEPA loans, number one? Is that something that would be helpful?

And second is that the HOEPA legislation expressly grants the Federal Reserve broad authority to issue regulations to restrict anything that is unfair, abusive, or a deceptive practice. Would using that authority to define loan flipping as an unfair, deceptive, abusive practice enhance, say, the Board's ability to enforce and regulate the practices of the industry?

Mr. MILLER. It may well do that and potentially would be very constructive. One of the ways to deal with flipping is the net tangible benefit concept, that if there is a refinancing done in a relatively short time there would have to be a net tangible benefit for the individual as a result of the refinancing rather than the opposite, destructive credit, that I talked about. That is one concept that has been discussed.

In terms of enforcement, you know, I think that there is room for a lot more enforcement. The problem is resources. One thing that was mentioned is a fund where there would be a small charge for each loan transaction put into an enforcement fund. That can be done perhaps at the State level. There is something you can do to provide funds to the States to enforce.

That would definitely be helpful. I mean, we see the benefits of us being on the beat with the Household case, and other cases that we are looking at. But it is not strictly an enforcement problem. It is a problem that the law can be constructive in. The industry can do a lot to clean itself up and, as I mentioned, some of those are doing that.

I do sense sort of an irony of some people calling for greater enforcement as they call at the same time for preemption that would take away some of the important laws to enforce. There is an inconsistency there.

Chairman BACHUS. Thank you. We sometimes on this committee, after time has expired, we ask another question. I am not going to do that. And we are just—if somebody is answering when the 5 minutes runs out, that is the 5 minutes. With that, Ms. Waters.

Ms. WATERS. Thank very much, Mr. Chairman. There are a number of characteristics of predatory lending that are clearly identifiable. You were just asking about loan flipping, which we think is—some of us believe to be one of the most egregious characteristics of predatory lending. But let me just ask about a few of these.

Let me ask the Mortgage Brokers Association representative about loan flipping. Do you believe that we should just outlaw this practice, or put a limit on the number of times a loan can be refinanced? What can you tell us about loan flipping that will help to get rid of the abusive practices and the harm to consumers that we see with this practice?

Mr. PICKEL. Well, there is a couple of things.

Ms. WATERS. What is our first—Mr. Crouch, is it? Mr. Couch.

Mr. COUCH. Yes. First, your question underscores one of the really difficult parts of this debate. You have suggested that loan flipping is a bad practice, and I would agree with you.

Then we would immediately have to define loan flipping. For instance, personally I refinanced my house twice in 7 months. It was not an abusive situation, or I don't think it was an abusive situation. My own bank did it. In both cases I lowered my interest rate.

Ms. WATERS. May I interrupt you and get to the kind of loan flipping that I am talking about? A borrower is in trouble. They can't make their payments. They are in danger of foreclosure. The lender says, let me refinance this loan for you. And in doing that, they have to pay all of the charges that are required with refinancing, et cetera. And this is the kind of loan where the borrower is not able to really pay, and they keep getting deeper and deeper into trouble and maybe flipped a couple of times, and still the foreclosure takes place. That is what I am trying to get at.

Mr. COUCH. Well, as so often is the case in these debates, dealing with hypotheticals makes it very difficult. My bank, we would not refinance someone that didn't have a prospect for repaying their debt.

Ms. WATERS. Tell me what you think is a bad loan flipping practice.

Mr. COUCH. Well, I can describe a number of practices that——

Ms. WATERS. Just give me one.

Mr. COUCH. An instance where someone is deceived into repetitively refinancing their loan for the purpose of stripping out their equity would be a predatory practice. It would also be illegal currently. It would be a fraudulent instance, and it would be illegal under current law.

Currently there are 22 Federal statutes that govern the application, funding approval and servicing of mortgage loans. Those laws, if properly enforced, would in fact take care of the vast majority of these situations that are oftentimes mentioned as abusive.

Ms. WATERS. Okay. So it is your feeling there are enough laws on the books, that we don't need to do anything else, that we should just enforce the law?

Mr. COUCH. Well, as I stated in my testimony, the Mortgage Bankers Association believes that the most effective tool for addressing issues of abusive lending are an educated consumer so——

Ms. WATERS. Okay. I have you. I understand you. What about balloon payments? Anybody? Should we just outlaw balloon payments?

Mr. COUCH. Would you like me to address that as well?

Ms. WATERS. No, you aren't doing too good.

Mr. NADON. Maybe I could give a little bit of an answer to that, at least from a lender's perspective. There are circumstances for some borrowers where in my opinion a balloon payment might be reasonable. But for most people I don't think that it is, because the amount of money that is required, it is very hard for most people to legitimately think that 5 or 6 years down the road they are going to have enough money to pay something. They won't know what the market conditions are going to be. They won't know what interest rates are going to be, they don't necessarily know a lot of the changes in the economy or even their employment.

So I would think we would want, at least from CFAL's perspective, to have very tight controls on when it would be appropriate to have a balloon payment. I can say, though, with that, that I have had some friends of mine, over time that they managed having a balloon payment on a particular property with a specific purpose on the property, and they managed it very well. But they are more sophisticated, they had a higher income level. They really had a better understanding of what they were entering into.

Mr. MILLER. And I think that is a very good point, that balloon payments make sense very rarely, and when they do make sense it is often in the prime market. It is often people that are in a very difficult situation. In the subprime market they very rarely make sense. They are almost always misleading. People don't know that it is a balloon payment, and then when they are done making payments they are going to owe a huge amount of money. In the subprime market balloons are a very, very serious problem and very rarely in the interest of the consumer.

Chairman BACHUS. Thank you.

Mrs. Kelly.

Mrs. KELLY. Thank you, Mr. Chairman. First of all, Mr. Chairman, I would like to enter into the record a letter written by myself and several other members of this committee to Mr. Hawke at the OCC.

Chairman BACHUS. Thank you. Without objection.

[The following information can be found on page 289 in the appendix.]

Mrs. KELLY. Thank you. Attorney General Miller, your experience with the investigations on these issues qualifies you to address the issue of whether or not a State Attorney General can protect consumers without the constant—and I am using this as a euphemism—help from the Federal Government regulators?

Do you agree that there is a middle ground where local perspectives and practices can be respected by banking law, or do you feel that the Federal Government needs to get in here and adjust what is being done by the States?

Mr. MILLER. I think that the current system, up until now, where States and Feds enjoy a concurrent responsibility and concurrent authority is the very best one. And a good example is in predatory lending, where the States were doing the case with Household at the same time the FTC was doing the case with Associates, CitiGroup.

We talked a little bit back and forth as to where we were at on the two cases. That is a very, very healthy situation. What is being proposed at the OCC to effectively take the States out of the joint effort in basic consumer protection dealing with national banks is just the wrong step. I think that we provide a good service, an effective service.

I think two viewpoints are better than one on these issues. You know, I couldn't agree more with I hope what is in your letter, saying that the States should continue to have this responsibility that we have had traditionally and I think executed very well.

Mrs. KELLY. Thank you. I hope my letter lives up to what your expectation is. But I also want you to know I intend to ask Chairman Oxley for a hearing. I chair the Oversight and Investigations Subcommittee, and I would like to have a hearing on whether or not the OCC is setting a policy that is going to preempt State laws. I think we need a clear set of principles about what Congressional mandates are all about on this.

I am just not sure that the OCC has followed our Congressional mandates. And I would like to go back to you, Attorney General Miller, and ask you, is it your opinion that you think that Congress is—that that is a good idea? Do you think that Congress ought to have some hearings on the OCC's action before the OCC continues on with its intended course, apparently?

Mr. MILLER. I couldn't agree more, and please invite me back. I would like to come back and testify again. I think it is a very, very important issue. And what is being proposed is a radical change from what we have known, you know, throughout our Republic, this idea that State Attorney Generals and other State officials have for a long, long time enforced consumer protection laws, State laws, against national banks. And that has worked and worked very well. And what the OCC is now saying, and just think about this, that they can preempt certain State laws. We understand that. We might quarrel about which, but we understand they can preempt certain State laws that deal with national banks. But then they are saying, what State laws remain States can't enforce. We can't enforce even State laws relative to national banks, even a consumer credit, a routine consumer credit claim like a simple credit card issue, that if an Iowan came to me and wanted me to try and resolve this basic issue, a simple issue with a national bank, we couldn't do it, according to the OCC now.

This is just a huge change. And what I have argued in another context is really a dagger in the heart of Federalism, that States cannot even enforce State law. That is wrong and I would welcome your hearing and talk more and be more upset even in that hearing.

Mrs. KELLY. Well, sir, I hope that we are able to work with you and be able to bring that hearing into reality.

I want to just go very quickly to Mr. Couch and just thank you very much for what I believe the MBA has tackled in terms of consumer financial literacy.

I am wondering if you think we should consider beefing up the financial literacy programs for home buyers at HUD?

Mr. COUCH. Well, Congresswoman, thank you for recognizing our efforts in this area. We, over 2 years ago, came out with our Stop Market Fraud Campaign. This year we translated it into Spanish. Tomorrow, I will be in Dearborn, Michigan, to announce the translation of the program into Arabic for the Arab community there in Dearborn. So thank you for that recognition.

I will go back to what I said earlier. Consumer education, wherever it may come, and I compliment the Congressman for his comments earlier about the provisions in his proposed legislation in that regard. Consumer education empowers the consumer to take advantage of what is already a very competitive marketplace.

Every Sunday morning in Birmingham, Alabama, my prices are run in the Sunday newspaper right next to my 30 closest competitors along with telephone numbers and ways to shop us against each other. So if we can educate the consumer and keep the marketplace competitive, we can lick this.

Mrs. KELLY. Thank you very much.

Chairman BACHUS. Thank you. The order on the Democratic side is Mr. Sanders, Mr. Watt, Mr. Lucas, Mr. Scott and Mrs. McCarthy, Mr. Crowley. Those are the next ones coming up. I am just going down the list that I have gotten.

Mr. Lucas, Mr. Watt and Mr. Sanders have agreed to let Mr. Lucas go in front of them. He has got another engagement.

Ms. VELAZQUEZ. Mr. Chairman, I have been losing weight, but I am not invisible, and I have been here, and I was one of the first who came here for this hearing.

Chairman BACHUS. What I will do, while he is asking his questions, I will give this list to the Democratic side and let you all come up with the order.

Mr. WATT. She actually made her opening statement in front of me.

Chairman BACHUS. As I say, I didn't prepare this. But what I will do is I will put her ahead. I will do that, because if you all just tell me what is accurate, I will change it.

Mr. CROWLEY. I was here first.

Mr. LUCAS OF KENTUCKY. Be quiet, Mr. Crowley.

My first question here is for Attorney General Miller. There is a lot of talk about net tangible benefit. How would you define net tangible benefit in a minute or less?

Mr. MILLER. Well, it is a somewhat amorphous concept, as you suggest, and it is clear at the extremes. It is clear when someone refinances and gets a lower interest rate, for instance, that obviously there is a net tangible benefit. When there is a refinancing at a relatively short time after the previous loan, and none of the changes are beneficial to the consumer, and he or she ends up paying 5 or more points, obviously there is no net tangible benefit.

But I think the concept is, looking at destructive credit and constructive credit, is the consumer better off after having made the refinancing looking at the basic terms and the purpose of the consumer? Or is the consumer without any real advantage going further and further away into destructive debt?

Mr. LUCAS OF KENTUCKY. Thank you. The next question is——

Mr. BROWN. If I may just add to that. In North Carolina, we looked at that as a broad spectrum. But when we look at a situation that we had in North Carolina, where a woman's husband died in Vietnam and needed to have some financing and went to her lender and got a 13 percent loan at the time, but also 10 percent fees tacked on and went into foreclosure and is now renting her place, well, is that what is not tangible?

I think we have to get some of the experience on the lower levels and begin to look at the actual effect, as my honorable colleague has said.

Mr. LUCAS OF KENTUCKY. Thank you. My next question is for Mr. Nadon. Do you think that it is really necessary to have extended assignee liability that makes Wall Street investors and pension funds liable? Why can't the liability buck stop with big lenders like you?

Mr. NADON. Well, we don't have a problem with it stopping with a big lender like us, because it is the larger lenders that are the ones that are doing the securitizations in the first place. The smaller players or those sometimes referred to as the marginal lenders don't really have the resources, the financial strength to go into the market doing the securitization themselves. So they ultimately wind up selling their product to maybe a company like ours or some of our competitors or selling them in small pools to aggregators who then take them to the market.

The problem that we have seen on the assignee liability language is that no one has been able to draft something yet in the State laws that we have seen, aside from perhaps—the one that got the closest to getting it right I think is in North Carolina, to doing it in such a way that it does not scare off the capital markets.

The good example that was in Georgia, it was sufficiently vague and unclear that the rating agencies, principally S&P, was not able to quantify the risk. And if they could not quantify the risk, they can't do their job for those people that would ultimately be the purchasers of the bonds.

As a result of that, those of us that are completely dependent on the capital markets, Option One Mortgage is one of those companies, and one of the larger ones in this country in this business, we were just shut off whether we liked the law in Georgia or not. We could no longer lend in that State. That is the concern that we have with the way that the language is crafted. There is probably an answer in there, but it is not the one that we have had come out in all of the different cities and States so far.

Mr. LUCAS OF KENTUCKY. Another question. We all know that mortgage brokers, they originate the majority of these loans. Do you think that current State laws are adequate for regulating these brokers?

Mr. NADON. No, I don't. And that is one of the serious problems that we have in this country today, is that if you go from State to State the rules on how you can become a broker and what kind of requirements you have to have really do vary. So it is very hard to get consistency in the quality of the brokers in a State-to-State type basis.

Another serious problem is that there are bad players in the broker industry. Unfortunately, some people are more interested in making money for themselves and really not caring at all what happens to the end borrower. But there isn't a way for us right now as lenders to identify who those people are.

So all that happens now is when we find them we cut them off. So we won't do business with them anymore, and in some instances our company has actually gotten the FBI and the police involved to try to put them completely out of business.

But when those brokers get suspended or terminated from us, then they just submit their application to do business with an Ameriquest, a New Century or a host of other lenders out there. And they don't have a way that they can identify in the approval process that that broker is a bad player.

And one of the things that is in the Ney-Lucas bill, which we like, is trying to create a national database which would allow us to do just that and try to create standards across the country for how a broker should behave.

Mr. LUCAS OF KENTUCKY. Thank you, Mr. Chairman.

Chairman NEY. [Presiding] Mr. Miller of California.

Mr. MILLER OF CALIFORNIA. Thank you, Mr. Chairman. When we look at the recent success of the subprime market, and that is not talking about predatory lending, but subprime home equity loans have grown 66,000 in 1993 to 856,000 in 1999. That is huge. And when you look at the other side of the subprime to purchase homes, it has grown from 16,000 to 263.

And these really benefit people who have blemishes on their credit rating, who have no place else to go. And this patchwork of State and local laws that are being developed and created by well-intended individuals is rather scary.

In Georgia alone, if you look at theirs, 35 companies, huge companies, said they would not be able to buy on the secondary market. Those include Freddie and Fannie. That is a huge, huge impact on the market.

I talked to one lender in California about the potential impact of Los Angeles and their ordinance that is being somewhat modified and adjusted at this point in time, and I was told that the loan volume in Los Angeles alone will decrease by 65 percent. This one lender, that is $600 million less mortgages for one company in Los Angeles alone.

And Attorney General Miller, I am kind of partial to that name, so I guess I will address this question to you. Can you kind of expand on how this patchwork of laws and well-intended ideas might impact the overall market for subprime? And do you not see some consistency being required from Congress to deal with this issue?

Mr. MILLER. First of all, I agree wholeheartedly with you that the subprime market has expanded dramatically in the last 10 years. By and large that has been a very, very good thing. And some people, you know, want to point out that subprime and predatory are different, and that is clearly right. Predatory is only a small piece of the subprime market.

But you know, I am a believer in democracy, and I am a believer that States are the laboratories of democracy, and I don't think the Georgia experience was necessarily a bad experience in this sense—that they appeared to go too far on assignee liability and created some problems of availability, so they had to pull back. So, you know, what did we learn from that?

Well, we learned not to go that far. And Georgia citizens weren't really impacted terribly because they made the change. That is how democracy works, and that is how the laboratories of democracy work. We know from the discussion today that North Carolina has found a very, very good balance that States should look to emulate.

I think working through the States and working through these laboratories of democracy is a very good thing. And as George mentioned, they can be self-corrected very easily. It is not like having to go through Congress and pass an act. If there is a problem, legislatures can move very quickly. They did that in Georgia, and I think that is fine.

I think we are learning more and more about what needs to be done and, in the case of Georgia, what shouldn't be done. That is healthy. That is not bad. That is our Federal system.

Mr. MILLER OF CALIFORNIA. Laboratories of democracy is one argument. We recently went through the argument with Freddie and Fannie as an example of how do you develop programs and, under that umbrella, the products that can be immediately put into the marketplace. And you are dealing with major lenders here who are trying to lend to every State in the Union and every community and county within those States.

And when you have each city coming up, Oakland having their own, Los Angeles having their own, Pittsburgh having theirs, some other State having theirs, don't you think there is going to be a dramatic impact on loan availability to consumers and consistency for consumers? Does not that impact those individuals who are, you know, having difficulty sometimes qualifying for subprime? Doesn't that impact the market overall?

Mr. MILLER. If I can respond. I don't think so, because, you know, look at the statistics you just cited, this enormous growth in the subprime market while all of those things were going on. I have less sympathy, and maybe it is because of my perspective of localities doing separate statutes.

Mr. MILLER OF CALIFORNIA. But these changes have been recent. Georgia was 2002. A lot of them are this year even. So it is not going back 10 years.

Mr. MILLER. North Carolina is 40 months ago, and other changes have taken place as well, and it hasn't choked it off, and I don't think it will. And the point is where it does the market really gets involved and says, okay, we are not going to play there. So then the locality or the State has to change the law. That is part of the democratic process.

And with this overwhelming amount of money that I referred to in the subprime market, you know, there is some margin for error.

There is margin for give. I am not concerned that people are not going to be able to get loans that should get loans because of this experimentation and this give and take.

Mr. NADON. If it would be appropriate for me to enhance some of the comments, because I actually agree with some of the things that Mr. Miller is saying. But the challenge for us is that we had the Georgia experience, where we all—all of the good lenders had to pull out because of the way that we fell into the secondary market. That access got shut off to us.

That is going to happen again here at the end of this month in New Jersey. They have enacted—I think it is November 27th that it goes into effect. And under that legislation, the rating agencies have a similar issue to the one that they had in Georgia.

Our company alone is lending approximately a billion dollars a year in the State of New Jersey. About 60 to 70 percent of that business is going to go away as soon as that law goes into effect. So I would just say that there is consequences that we have to think through before we enact such legislation.

Chairman NEY. Thank you. Mr. Sanders, I am going to let you advise me who is next.

Mr. SANDERS. You are passing this buck to me?

Chairman NEY. Yes, sir, officially.

Mr. SANDERS. Thank you, Mr. Chairman. Let me direct my remarks, if I might to Mr. Miller, Mr. Brown and Mr. Fishbein.

The real discussion here is whether or not States and cities have the right to protect consumers. My understanding is there are about 20 States in this country, and 20 localities who have passed strong anti-predatory lending consumer legislation.

My understanding is that in your own State of North Carolina, according to the Coalition for Responsible Lending, the North Carolina anti-predatory lending law saved homeowners $100 million in its first year alone. So my question to you is, if the United States Congress takes what seems to be a rather Draconian action and says 20 States who elect their own Governors and Attorney Generals, who have passed legislation, we are wiping you out, 20 cities, we are wiping you out, we know better than you, what is the impact on North Carolina and in other States? What does this mean for consumers, and who is behind this? Who is hurt by this Federal action? Who benefits?

Why don't we start with the Attorney General? Mr. Miller.

Mr. MILLER. Well, consumers don't benefit in those 20 States. It would be incredibly sad to have North Carolina develop that law, building a consensus within their financial community, having it work and work well for 40 months now, consumers being saved I think you mentioned a hundred million dollars, for Congress to come in and say, well, we know better, that is too strong a law. And I think all of the proposals are far short of North Carolina, I think it would be wrong for Congress to decide that North Carolina law, even though it works and we know it works, it is the best in the country, the people of North Carolina can't have that, because for some reason we want uniform authority throughout the country.

What Congress should do, if they wanted to act, in my opinion, is basically enact the North Carolina statute as the national standard and make that a floor. Let the States experiment further. If we can find something better than North Carolina after a few years, come back and do that. That would make the most sense.

And, as I say, it is not going to impact credit. Where credit is impacted, there is a pushback. Where people, where a large number of people can't get credit, there is a pushback, there is a change in the State law, a change in the ordinance. It is self-correcting out there.

Mr. SANDERS. I agree with you, and I think it would be outrageous for the United States Congress to take away what so many States and municipalities have done. Mr. Brown and Mr. Fishbein.

Mr. Brown, do you want to comment on that?

Mr. BROWN. Yes. I have to echo what Mr. Miller said. In North Carolina, if the North Carolina law had not been in place, we would have continued to see an erosion of the position, the financial wealth and the stripping would have continued. So that we have estimated, as we said before, about $9.1 billion you have stated that we see lost as a result of the predatory practices. That number would continue to escalate.

Mr. SANDERS. So you are saying consumers will be substantially harmed?

Mr. BROWN. Consumers would be substantially harmed, and all levels of consumers. The interesting thing, if I may say that we are looking at, sometimes when we are looking at this market, the mortgage market as a global marketplace, and that we are concerned about its impacts in certain areas of secondary markets, et cetera.

But we have to begin with the homeowner, and we have to begin in looking at ways in which we can quickly address the issues that arise in our localities. And to take away that, this is a laboratory of democracy, this is pure democracy, period, which is no laboratory. And we cannot lose that. I absolutely agree with Mr. Miller. If there is going to be a national law and there is a floor, North Carolina has the example what that floor ought to be.

Mr. SANDERS. Congratulations on your work. Let me ask Mr. Fishbein.

Mr. FISHBEIN. I want to agree with the remarks by Attorney General Miller and Mr. Brown. I would just add that some see what has happened in the past years with State legislation as somehow a negative outcome, when in fact I think it has been a very positive one. Because States have been experimenting and developing and addressing some very complicated issues, and they have the ability to respond and change, and the proper balance is emerging.

What I suspect you will see over time is that when the right balance is struck, you will see more and more States enacting very similar types of laws, whether it be North Carolina or others.

Secondly, we don't think this is an either/or situation. I think it is correct to say that the Federal regulation can be improved and establish certain minimum requirements. If those are good requirements, that will probably act as a disincentive or deterrence from States feeling a need to address the issue. But if there are particular issues in their State that are not addressed by Federal law, there certainly should be a continuing opportunity for States to regulate in that area.

Mr. SANDERS. Thank you very much. Thank you, Mr. Chairman.

Chairman NEY. Mr. Scott of Georgia.

Mr. SCOTT. Yes, sir. Thank you very much, Mr. Chairman. I appreciate that. I wanted to add two lines of thought. First one is on financial literacy. I certainly appreciate the comments that all of you have on both sides of this for the need for financial literacy, and, of course as I mentioned earlier, we certainly want to thank Chairman Ney for incorporating our financial literacy bill in the main bill.

We have got several components of that, one of which is the toll-free number, the grants to the States, setting up the local advisory predatory lending committees.

So far we have about $50 million incorporated through Federal funding for our efforts. I wanted each of you to kind of respond how you, or what resources that you could bring to assist us in that effort. My colleague, Congressman Ford, mentioned our effort to expand this financial literacy to our K through 12, with an amendment that I offered with Mrs. Biggert, Judy Biggert. We did just that, initiating $5 million initially, and securing another $80 million through the Securities and Exchange Global Research Fund.

Financial literacy takes money. It takes support, and I know that one or two of you mentioned your support for that. Could you give us some specific ways which you in the private sector could add to assist us in funding these financial literacy programs as a joint function with the public and private sector?

And the other question I want to have, because I know I got my 5 minutes, is in addition to the financial literacy, once we have got that into the bill, there is another contentious issue here, which we have touched upon, which is the preemption issue. And I come from Georgia. We are the laboratory of everything. We have not been as successful as North Carolina, but we have been in there punching.

And as a State Senator, I helped to author the first bill in response to Fleet Finance coming in and using our usury laws, which we put licensing and that sort of thing on. I was very concerned, because I was one of the authors of the Georgia Fair Lending Act, in which the Office of the Comptroller of the Currency came in and ruled on the assignee liability, and I felt at that time that the assignee liability was going to bring some serious issues. I think we can learn from the Georgia experience and how to craft this legislation to do two things, carve out the role for the Federal Government. Instead of preemption, which I do not agree with, I think you are absolutely right, I think there is a role for the States. I think they are unique. Each State has it own characteristics. And coming from a State legislature, I know the value of being able to be on the ground responding to that.

But I think through the assignee liability issue that the Office of the Controller of Currency brought up comes the role of the Federal Government, and that is to set the national standard. If we had set a national standard for assignee liability, that would have been a guide that we could have used in Georgia to avoid the whole thing.

Perhaps we can come up with a national standard on balloon payments, on some of the other definitions that we have. I would like to get your take on those two points. One, your support in bringing resources to help us with our financial literacy program as an ongoing basis.

And, thirdly, your response to the State preemption issue and the necessity of carving out a role on our developing a national standard on those issues.

Mr. NADON. First, on the educational part, that is something that we really believe strongly in, that in the long term the real answers to most of these issues rest in education, consumer education, improving financial literacy. Because we strongly believe that if people really do understand the terms of anything they are entering into, if they know what questions to ask, and they know when a good answer and a bad answer comes out, they are probably not going to get themselves in as much trouble.

So we think that is very important. So there are a number of things that we do, and we actually sponsor Jump Start, among other things, which is a program that goes through K through 12, where we are actually giving money and sending people out to start educating kids when they are going through that part of their life on some of these financial matters that they never hear about in high school or in college.

We have also got an Option One Mortgage University that we have got off the ground now that works across the country to educate brokers, and we are going to expand it to get out to the average consumers. We are now talking with Fannie Mae to partner with them to do it across the country and with the MBA to help do things across the country on a more national scale with all of us contributing dollars to try to make it happen.

We are working with the Fannie Mae Foundation to try to find more ways that we can get better informational tools in the hands of the borrowers at the time that they apply with us, not before they are ready to sign loan docs, but when they are first getting an application in the system, so that they can know places that they can go to get better information.

So we are very focused on the educational part. And if I can just take a couple of seconds just to give a different point of view on the preemption part or the State versus the locality or State versus national.

One of the concerns that we have if we allow all of the States or cities to craft their own legislation is that I will have a neighbor some day who lives right down the street from me, because we are right on the border between my community, Laguna Niguel and Dana Point. And Dana Point may have a law that is different from the one Laguna Niguel has. And simply by virtue of buying his house four doors farther down the street and across the street from us, he may not have as much protection as I will have, if Laguna Niguel crafts a better law. We have a serious concern about that.

It is interesting to note that in the North Carolina law, which I believe there is a lot of very good qualities in the North Carolina law, the people that crafted it, in my opinion, I think were very well intended and pretty well educated. Martin Eakes is someone

I happen to have a lot of respect for. I think they did a really nice job.

But I think they have got preemption in there with localities, if I am right. So they are saying to the cities you cannot come in and write a new rule in one of our cities in North Carolina that is going to supersede what we do in the State. And I think the reason behind that is, maybe the same reasoning that we are saying on a national scale, we think it should be a national law versus every State or city doing something.

Mr. PICKEL. Mr. Scott, I can speak for NAMB and tell you that because we are so close to the consumer with 16,000 members, we will do everything we can to take education to the streets. We have already done a course called, Are You Prepared to Head Down the Road to Home Ownership? It is in English and in Spanish. It is designed for that borrower who is a first time homeowner or home buyer who really doesn't know where they are going.

So we are committed to helping educate people to know really what they are getting into. The other thing I would like to comment on, there is another aspect of financial literacy, and that is making sure that the people who are there, you know whom you are dealing with.

There was a comment earlier that characterized mortgage brokers I believe somewhat unfairly as being the people who are getting people into these home loans that are predatory, and I don't think that is the case.

NAMB has worked, I can't tell you in how many States, I believe it is 20 States, where we have tried to get the Model State Statute initiative in there, where we want licensure, education, prelicensure, continuing education, and a registration. We believe that there also ought to be a national registry for all loan officers, because that guy that I fire for doing something wrong, I want to know where he goes, whether it is a mortgage banker, a mortgage broker, or a bank, or a credit union or wherever he goes.

So I think the other part of financial literacy is making sure that the right people are doing the right things as well for our consumers in the United States.

Chairman NEY. Your time has expired.

Mr. SCOTT. Mr. Chairman, I just wanted to make this one last point, and I will be through. I should have narrowed and focused my point a little further. But I do believe that, as one of the panelists had mentioned, the possibility of incorporating some fee structure added in that could go to assist our efforts in what we are doing in the law itself to help us to fund those programs.

And I think that that—is that true?

Mr. NADON. That is true. CFAL believes it is a very creative way that the industry might actually be able to contribute. And we know that funding for some of these things, educational, even enforcement, can be difficult in States or cities these days. So we are saying let us pony up some of the money for that out of every loan that we fund. We are not sure how it is administered, but we know we can bring some money to the table to help the process.

Mr. SCOTT. That is what I wanted to see if we could not explore, Mr. Chairman, as we move forward with our financial literacy bill, a way for the private sector to help us. Thank you.

Chairman NEY. Thank you. I would also want to submit for the record, several groups have contacted the committee to ask their statements be submitted for the record. Therefore, without objection, the statements of America's Community Bankers, American Land Title Association, Consumer Mortgage Coalition, the Credit Union National Association, as well as a study by Michael Statton of the Credit Research Center on the effects of the North Carolina predatory lending law will be entered into the record.

[The following information can be found on pages 330, 334, 392, 418 and 446 in the appendix.]

Chairman NEY. I would also note, and I am going to make my questions very brief, and if I can get some brief answers, because we have another panel that has yet to come. I think it has been a good healthy discussion today.

Mr. Pickel, I just wanted to focus, with a brief answer if I could, what is the critical difference of the State registry versus the national registry, in your opinion?

Mr. PICKEL. Well, the reason we would like a national registry is we want to track the guy if he goes State to State. Several States have a registry. In fact, in Kansas we use the Model State Statute initiative. We license both loan officers, if they are a mortgage banker or mortgage broker. We require continuing Ed.

We just feel like if we have a national registry similar to the one that NASD, our self-regulating organization, we would like to follow that model. Currently, we feel like that could take the bad actors out of the business, just like on the mutual fund situations going on right now. You can find those guys and you can get them out.

Chairman NEY. I know that there was a case of a guy that did hideous things, and he went to another State and did them. And unless that State had a good registry and you are able to catch them right when they came in, if you don't have a national registry you are just not going to catch a person that keeps going place to place. So I was wondering if you thought it was a critical part.

The other question I have is for the Attorney General. In your testimony, Attorney General, you made the point that North Carolina law has reduced access to predatory lending, not access to appropriate lending. And I wondered if you could talk a little bit about how you came to that conclusion, and is there any study towards it?

Mr. MILLER. Yes, there are, Mr. Chairman. In fact, I was—it was previewed by Congressman Miller, who talked about the UNC study. The UNC study is, I think, the best study, the most comprehensive study of the North Carolina situation.

Chairman NEY. If I could, Mr. Attorney General, the other point I want to make now, in fairness, not to wait for your answer, is that there have been arguments because of the law, in fact, people have scaled back the amount of credit available, therefore there is less credit available to people.

So that is why I wondered about your conclusion.

Mr. MILLER. Exactly. And the study indicated that as to purchase money transactions for homes, buying the home for the first time, over a 4-year period North Carolina lending went up 43 percent, which is at exactly the same as the rest of the South.

On refinancing, they may have dropped off a small amount. But we would argue that that would be natural, that at the margin if destructive debt is being eliminated, there would be somewhat less financing. And that would be a good thing if it was the financing that was destructive. There is, I don't think, any suggestion by anybody, Congressman Watt and George Brown would know better than I, that there is a dearth of credit in North Carolina, that there is a problem with subprime lending not being available. I don't think there is any indication of that.

And the North Carolina study indicates that probably it was targeted to do exactly what it did, not harm constructive lending, but to limit, at least at the margin, destructive lending.

Chairman NEY. Do you think it was different than what Georgia did, because, as you know, Georgia had to come back and undo a few things, especially in assignee liability.

Mr. MILLER. It was different in terms of assignee liability. And, you know, I think—I am a great believer in the concept of laboratories of democracy. The States are laboratories of democracy.

We learned a lot about what should be done in North Carolina. Georgia, you know, probably pushed assignee liability too far. We have learned something from that, and we really should be indebted to both States, because we learned a lot from both States, and that is how our system should work at the State level.

Chairman NEY. I also think really, coming from the State house, originally in the State Senate in Ohio, and being

very—obviously I am for home rule and States rights, but I think if you had asked me 15 years ago about standards, I would have said we were going after preempting the States. Things have changed so much in the United States that now what happens in Georgia affects the rest of the country and what happens in North Carolina or Ohio.

That is why I look more towards the discussion, at least, of a national standard; whereas things were pretty well set, I think technologically in the way we operated in the United States 15 some years ago, that, you know, the fact that we didn't even have interstate banking in the State of Ohio until around 1988 or 1989.

So I just think a national standard is—more of a national standard than a total, you know, preemption of the States, I think a lot of things have evolved to at least that is a discussion point these days.

Mr. MILLER. That is certainly a worthwhile discussion. What I suggest in that regard is that the best system we know is North Carolina. If you wanted to have national legislation parallel North Carolina, because that has worked best, but don't preempt the States. Let the States experiment around the edges as well.

But I think if North Carolina is as good as we think, most States wouldn't change it, wouldn't change much. If some State found a better way to do it, you could come back in a few years and make that part of the national standard. I think that is the best way to balance the two realities that you just described.

Chairman NEY. Thank you.

Mr. COUCH. Congressman, I was just going to follow up, with all due respect to General Miller. The statistics that he keeps talking about on the edges, if you look on page 19 of the UNC study, which by the way was funded by Mr. Brown's group, the drop in North Carolina in the seven quarters following enactment of the statute was 20 percent in subprime refinances according to that study.

Now, there are others that suggest that it was much greater than that. We at the Mortgage Bankers have extrapolated that. That works out to be about $300 million of loans that weren't made to 4,000 borrowers. So it is important to read the entire study, I think, and all of the studies that are out there regarding North Carolina.

Mr. BROWN. Well, Mr. Chairman, if we really honestly look at the study from top to bottom, the reduction of some of the refinances, mortgages, I think, again, is not just hitting at the perimeter or the fringes, it is hitting at the problem that we want to address in America, period. That is to provide that the incidents of predator lending practices naturally, when we are talking about flipping and other equity stripping features, tend to be right at that particular aspect of refinancing.

And the law, a very balanced law with fundamental, massive, unanimous statewide participation said, and it shows from the study, that we have gotten rid of situations that could turn up like the woman I have talked about before, where we are putting at risk homeowners who could, through the added-on fees and flipping of mortgages, might wind up in a very serious foreclosure situation.

So we have not dried up credit, it has increased. We have reduced by 72 percent prepayment—loans that are being made with prepayment penalties. Almost in my view, wiped it out. The UNC study, one of the best, has shown us that we have done exactly what the law intended to do.

Chairman NEY. Thank you.

Ms. Velazquez.

Ms. VELAZQUEZ. Thank you, Mr. Chairman. Mr. Brown, do you have any suggestions as to how this committee can resolve the issue of assignee liability in a way that protects the consumers and allows companies who purchase loans on the secondary market the ability to still be successful?

Mr. BROWN. That is a tough question for a newcomer like me. However, let me take a crack at it. It is very clear that the fundamental issue of assignee liability has to be there to protect the homeowner whose mortgage is being purchased and who has to be in a position to defend situations in which there arose a predator lending practice. We have got to have that.

The extent to which we can look at other examples in the Federal Government, in the consumer lending area, to begin with, the SEC's holder, in due course holder provisions, to be able to look at things such as safe harbors and how we begin to fashion, if we think it is prudent, certain caps or assignee liability provisions. These kind of things are not done overnight.

To the extent that we are starting here today, we would love to work with you and begin to fashion ways in which we can come up with provisions that—Georgia, in their desire to get into predatory lending, saw that the road that they took in one level was not the right road and came back and changed that, through the way in which it ought to be, local, local provisions and local government.

So we think there are some things we can look at. Some examples come from this whole issue of assigning liability. It is not uncommon, period. And I am sure, as many customers say in the mortgage lending business, it is there. We can fashion ways to do it that will protect the consumer and will not provide an opportunity for raiding agencies to say that it is going to impact the liquidity of the secondary market. Done every day. We have got to take a look at how we can address it in this particular area.

Ms. VELAZQUEZ. Thank you. Attorney General Miller, what are the failures in lender due diligence and quality control you have seen in the predatory lending cases you pursued, and how have they exacerbated the abuses that you prosecuted?

Mr. MILLER. I think the best example and the most unfortunate example of assignee responsibility or lack of responsibility is the FAMCO case, which was the worst case of predatory lending we have seen at the national level. And Lehman Brothers did the securitization there and were sued over that and held liable, at least in part, for their responsibility there.

It seems to me that on assignee liability you need to avoid the extremes. You need to avoid the extreme of making it too difficult, too risky, for the investment banking firm. You can do things like limit the liability to the amount lent, not have them be responsible for concepts like net tangible benefit, which I admitted were somewhat amorphous.

On the other hand, you need to avoid the idea that they have no liability at all. They should have to do some due diligence. If they know that they are dealing with a crook, or a bad operator, and they go ahead and securitize anyway, they should have to take responsibility for that because, again, FAMCO is the example. They were able to perpetrate their fraud and their harm much more dramatically because they could securitize.

Ms. VELAZQUEZ. Thank you. Mr. Fishbein, beyond stopping predatory lending, could you give us your opinion as to how anti-predatory lending laws help responsible lenders better serve minority and low income communities?

Mr. FISHBEIN. Well, I think the—as I have indicated in my testimony, subprime lending is so heavily concentrated in minority areas that it can cause particular problems in its own right,and what anti-predatory lending laws do, if they have the proper standards in place, is that they help to weed out and curb the worst practices. They help ensure that borrowers are getting into loans that are affordable, and therefore are less likely to go into foreclosure, which can have devastating effects on those families and their neighborhoods, and good protections we think is very helpful to the marketplace, results in better subprime lending occurring, and ultimately takes out some of the worst abuses that are bringing down the very purposes that they are intended to serve.

Ms. VELAZQUEZ. Thank you. Thank you, Mr. Chairman.

Chairman NEY. Thank you.

Mr. Watt.

Mr. WATT. Thank you, Mr. Chairman. I will be quick. I just want yes or no answers. Is there general agreement that the North Carolina statute is better than the Home Ownership and Equity Protection Act of 1994?

Mr. MILLER. Yes.

Mr. BROWN. Yes.

Mr. COUCH. No.

Mr. PICKEL. No.

Mr. WATT. So we have got two on the end that don't agree.

Okay. Is there general agreement that if Secretary Hawke's regulations go into effect, that the Home Ownership and Equity Protection Act would take precedence over the North Carolina law insofar as Federal institutions are concerned?

Mr. COUCH. National banks, yes.

Mr. WATT. National banks.

Mr. FISHBEIN. Let me go a little further than that, because the Controller has had a very aggressive form of preemption that he is proposing that would actually affect State chartered operating subsidiaries of national banks, and to that extent it would actually preempt State enforcement in that area as well. State chartered institutions would be preempted from having State laws apply to them.

Mr. WATT. Okay. Is it true that you all think that we need a hearing on that, on the proposal?

Mr. FISHBEIN. Yes.

Mr. WATT. I yield back, Mr. Chairman.

Chairman NEY. Thank you. And next would be Mr. Meeks.

Mr. MEEKS. Thank you, Mr. Chairman, and let me see if I can do this, maybe not as quick as Mr. Watt, but quickly.

I guess I will just ask this first of Mr. Pickel and Mr. Couch. It seems that very few prime lenders charge prepayment penalties, but the majority of subprime lenders do.

My question is if that is the case, doesn't it make it more difficult for people to improve their credit rating in a few areas to access better rates?

Mr. COUCH. I would probably debate with you the issue of do primary lenders ever charge prepayment penalties. We actually have products that we offer where if you are willing as a consumer to accept a prepayment penalty we will offer you a lower interest rate on your loan.

It is an advantage to consumers. We also, on occasion, will allow consumers to finance closing costs at the front end of the loan, and pay us back, in essence, through a slightly higher interest rate on the loan.

And the only way that works is if you have some assurance that the cash flows are going to continue for long enough to repay that loan, if you will, and prepayment penalties are a way of doing that.

It is important to point out we are also a commercial lender, and this year we will do a billion and a half dollars worth of commercial loans, multifamily, shopping centers, office buildings, those sorts of things, in virtually every, I can't think of an exception, in every loan, and these are sophisticated borrowers that we are lending to. In every loan we have a yield maintenance provision. If it is a fixed rate loan, we have a yield maintenance provision, in essence, a prepayment penalty. So it is not on its face an unconscionable term.

Mr. PICKEL. Sir, I think as brokers we sell the products that the lenders offer us. The prepayment penalty can always be bought out. I can tell you that in my own company a lot of times we will buy that out. I think the prepayment penalty can help do what Mr. Couch said. It can ensure the lender of a certain rate of return over a certain period of time. But our goal is to help the consumer, always has been. And what we really want to do is—I can tell you a number of instances where we have taken people out of subprime loans and put them into a conforming loan once they have got their credit back on track.

So if the prepayment penalty helps us to get a lower rate at the beginning for that consumer, then we like that. But we want the consumer to know what they are getting into. We want to tell them what it is, we want to tell them how long it lasts. We want to give them an option not to have it if they don't want it.

Mr. FISHBEIN. Congressman, if I can just comment on that. When you consider that a significant part of the subprime market is comprised of borrowers who would qualify for cheaper loans, so says Freddie Mac and Fannie Mae, then prepayment penalties are actually even more pernicious than that.

They are actually hooking people into paying on top of the higher interest rates they are already paying with back-end fees that in many cases that they were not aware of when they find out that they could qualify for a cheaper loan.

Mr. NADON. If I might be allowed to just add one comment to that. We do a lot of business with Fannie and Freddie over the years. Freddie was one of the biggest buyers of our bonds over the last 5 or 6 years, and they have done extensive due diligence on the loans that we produce. We are a nonprime originator, and their conclusion was that a small percentage of the loans, when you looked at the complete file, would have actually passed their automated underwriting engine. On a FICO score basis only, yeah, but there is a lot of other requirements that the prime loans have that are not part of the loans that we are originating. And because our borrowers didn't have 2 months of cash reserves, they were looking for more cash out than the prime lender was willing to do for them, or the guidelines would allow.

It is things like that, that actually took most of those loans out of qualifying, and Freddie was able to validate that, as has Fannie Mae, by doing personal due diligence on our loan originations for the last 6 years.

Mr. MEEKS. And I am just trying to get into how you do business. You know, folks are saying in my district how nonprime lenders usually charge unreasonably high rates and fees, and they don't make loans according to people's credit risks.

I am just asking you, I guess, because of your company and your business, can you explain to me how companies like yours price on the base of risk?

Mr. NADON. I am going to say it is an easy thing. It is easy to sort of understand the concept, but it gets more complex, obviously, in the doing.

But there are several layers of risk associated to our loans, and unlike the prime world where the rate—you qualify, everybody gets that same rate. So whether you had a 780 score, 685 score, whether it was 80 percent loan-to-value or 60 percent loan-to-value on a prime loan, you get the same rate.

Ours are actually priced according to the various layers of risk. So our minimum loan rates start in the 5 percent range and they work their way up to where our average coupons on our loans, the weighted average interest rate charged in our loan pools today are mid-7 percent range. We average today roughly 150 to 175 basis points higher on our average products than where the prime world is today. And we look at factors that—each on their own is a risk factor, things like the loan-to-value, the credit profile of the borrower, their past payment performance on a prior mortgage or mortgages that they have had.

We look at what their income-debt ratios are. We look to make sure that they can verify all of their cash flows. For some self-employed borrowers—we have a lot of small business owners that come to us, and so their cash flows are not consistent because they are not getting a regular paycheck every week. We look at how the cash flows are coming through.

We look at—all those various factors in and of themselves are credit components to it. And the ones that are on the low end of the scale—so loan-to-value is less, their debt-to-income ratio is lower, their credit performance is better, their past mortgage performance, payment performance is better—are paying a lower rate than those that may have a higher debt ratio. Or where the loan-to-value is higher means the risk we are taking is a little bit higher, are where those others layers of risk get started adding on. And that is what drives the rates up.

So if you were to look at our credit components, not isolated one by one, starting at the best quality and then adding those layers of risk, you would see the incremental increases in the interest rate charged on the loan based on the credit factors.

Mr. MEEKS. Thank you.

Chairman NEY. Mr. Crowley.

Mr. CROWLEY. Thank you, Mr. Chairman. I apparently have lost too much weight. So those—you weren't here before, Mr. Chairman.

Let me just ask a question that has been spinning around for a couple of days as I focus on this issue a great deal more. What product would have been available to individuals who have availed themselves of the subprime market had this product not expanded, or this market not expanded, over the last decade? Where would people who were able to avail themselves of getting a mortgage loan or getting a car loan or getting a small business loan—where would they have gotten that loan had they not had the vehicle of the subprime market to do it in?

It is for anyone, basically.

Mr. NADON. I can tell you from my personal experience—I have been in this business for a long time, almost 30 years now, and the way that we used to give money to these very same borrowers; they literally are the same people that I was lending to in 1977, 1978, and 1979, and I was doing it then in a finance company. And as recently as probably 10 or 12 years ago, the finance company rates could be upwards of 18 percent. So on a mortgage loan we had products that were priced at 18 percent with 10 points, 15-year, fully amortized, and that was the deal. You didn't have any negotiation on that.

That same borrower could come to us today on our various loan products and obtain a first mortgage in the 6 or 7 or 8 percent range, depending on the various credit criteria that they have got, and it could be either a 30-year fixed, it could be fixed for 2 or 3 years and then convert to an adjustable rate mortgage after that. Instead of paying 10 points, our weighted average points and fees run around 2-1/2.

So there has been a significant reduction in the cost of credit to these consumers and an increase in the kind of loan products that have been available to them, and that is because of the capital markets coming in. The securitization process has made access to capital for us different than it used to be, and it is more plentiful than it used to be. So you would have found people either going to a finance company with high rates or points, or going to what we used to call hard money lenders; those are people that frankly didn't care whether you paid the loan back or not because it became a rental access tool for them. They would foreclose on your house and use it as a rental.

Mr. CROWLEY. Would everyone agree on the panel that there has been some benefit to the expansion of the subprime market? Everyone agrees to that; is that correct?

Mr. FISHBEIN. But at the same time, it is important to understand that there are components of borrowers in the subprime market. And as I point out, some of them would qualify for cheaper loans.

Mr. CROWLEY. I would like to get to that point, too, because my next question is—because you, Mr. Fishbein, you point out an important issue that I think needs to be addressed as well. And that is an individual who applies for a loan, and instead of getting into the prime market, is shuffled into the subprime market. And I think that it is important to note, how can we—do you have any statistics on that or, for lack of a better word, evidence in terms of—a compilation of evidence to show that? Because I think it is important.

If a person could have been in the subprime—could have been in the prime and somehow was shuffled into the subprime, that is wrong. I mean, if it is racially motivated or if it is because of a lack of education, whatever the reason may be, I think it is wrong and it needs be addressed; and I think it is important to build a case to show that. I know in my district I talked about the benefits of subprime lending in terms of what it has done in terms of affording people wealth, varying degrees of wealth depending on where they live. But it certainly has had some positive benefits. And you pointed out one that I think is certainly—to me, is a striking one that needs to be addressed.

Mr. FISHBEIN. Well, my response to that is in two ways. One is, there is research. I mentioned before that Freddie Mac has conducted, and Fannie Mae has reached similar conclusions, that when they run people who have obtained subprime borrowers through their automated underwriting systems, that these people would qualify for cheaper and in many cases conventional prime loans. And we can talk about how large a percentage or how small a percentage, but there is some percentage of people that either because of lack of knowledge or lack of opportunity, or because subprime lending is aggressively sold to them and they may not have even been in the market for a loan, get into higher-cost loans than they qualify for.

But, secondly, the real change in the marketplace is, now we have subprime lenders that are affiliated with banking institutions and prime lenders. I think half of the top 10 subprime lenders are affiliated with banks. And there is no legal requirement that a person who walks into a subprime unit of one of these financial institutions gets referred to the prime unit because they qualify for cheaper loans. And in fact, the profit incentive is very much the opposite of that.

So, in fact, it is a "buyers beware" market out there. And I think the plain fact is, a lot of consumers just don't understand that, because in the past they felt they had to convince a lender to lend them money. Now, the lender is kind of peddling money to them, and they haven't made that psychological adjustment in some of the actions they have to take.

Mr. NADON. Although I would say that the evidence, in my opinion, would show very clearly that it is a small percentage of loans that would actually qualify for the full guidelines. I do agree that some of them wind up that way that should not. And we think that one of the ways to cure that, to prevent that from happening, is to make sure that there is a process to move the borrower up.

So like in our company, as an example, if we have people that come in that are qualifying for a prime-type loan, we have a company that does prime loans; one of our subsidiaries does prime loans.

So we just think that there should be an incentive built into this system, and your rewards systems or compensation systems should be such that it incents the right kind of behavior which will say, this person qualifies for this product rather than this higher product, so I am going to move him into this higher product. There are ways that you can actually put those kinds of processes in place in companies to ensure that things don't happen.

Mr. CROWLEY. As long as there is a vehicle to do it.

Mr. MILLER. Congressman, lenders know. I mean, they score these people. They know who qualifies for prime.

Mr. COUCH. Congressman, you raise a very good point though. At the Mortgage Bankers Association we are concerned that the effect of some of these laws is to drive reputable lenders out of the marketplace, thus restricting the flow. But nothing is done to handle or to satisfy the thirst for capital.

There is evidence that payday lending, for instance in North Carolina, has expanded rapidly since the statute was put on the books in 1999 and 2000. That—just as Mr. Nadon says, in North Carolina we have seen a growth in unsecured signature loans which are at a much higher rate. The effective rate is about 370 percent on a payday loan.

You have to ask the question, is the consumer better off if they are driven into one of these other sources for credit.

Chairman NEY. The time has expired.

Mr. Crowley, I want to apologize. You must have lost a little weight, so I let you go over a little extra.

Mr. Davis is a new member, and he has gained a few pounds, I think.

Mr. CROWLEY. It is a compliment. Thank you, Mr. Chairman.

Chairman NEY. Thank you.

Mr. Davis.

Mr. DAVIS. Thank you, Mr. Chairman. I think Mr. Crowley still has a little bit of an edge on me, though.

But let me try to focus on something that a number of the members alluded to in their opening statements, but you have not been asked about a lot, and that is the prevalence of subprime lending in the minority community. On one hand, I suppose that disparity is accounted for by the obvious wealth gap that exists in the minority and the Caucasian community. But in preparing for this hearing, I saw several statistics indicating that even in upper-income African American neighborhoods, the subprime rate is about double what it is in low-income white neighborhoods. Even controlling across class lines, in other words, there is a greater prevalence of subprime lending in black neighborhoods. And I want to get some comment from the panel on that point.

First of all, what is the reason for that? Give me some sense of why there is a higher subprime lending rate in upper-income black neighborhoods than in low-income white neighborhoods. Does anybody want to react to that?

Mr. BROWN. Yes. Let me give my views on that.

I think clearly one of the—and, Mr. Scott, I didn't have a chance to comment on your proposals for financial in-house counseling. I think it has been the desire from some of the lenders and some of our not so favored lenders to target markets in which they believe—in communities in which they believe they can, in fact, offer a product with certain yields that are higher than they ought to be. And that happens to be a lot of the communities that are, regardless of the income strata, that happen to be low-income—I said low-income, but minority, African American, or Latino communities. So there is that.

There is clearly the issue of the steering of individuals from the prime market to the subprime market.

Now, let me tell you, the marketing—and I have been there, and this is not just—this is empirical data here. I have been what was called a higher-income individual, and let me tell you, I was marketed to by many mortgage bankers who were offering products that in my young years didn't realize that I could perhaps go to another lender and secure prime. Now, that is just me; it means I talked to my neighbors. And so, when you look at credit lending, it is not going to just be me, it is going to be those impacted, my friends and colleagues in my neighborhood.

So there is—that sort of in my mind would be one of the reasons why you will see it in those communities.

Mr. DAVIS. Now, let me ask you a follow-up question, or all of you a follow-up question based upon that.

Under the current state of law—and I will direct this particularly toward General Miller. Under the current state of law in this country, is it illegal, does it violate any Federal statute that you know of for that kind of steering to go on?

Mr. MILLER. I think it would. I think it would violate some of the basic civil rights statutes.

Indeed, when we did our case with Household, we had to sort of put together an incredible coalition of sort of a consumer protection division's work plus civil rights work. Some of the issues in Household came out of the civil rights division. And, of course, we were partnered, in addition, with the mortgage regulators, and developed a wonderful partnership. But some of that case came out of the Civil Rights Division, and in particular, in Arizona, which was one of the leaders of our group.

Mr. DAVIS. Let me close on this observation since the time is running late.

One thing that is apparent to me as someone who, before I came here, practiced discrimination law on the plaintiff's side. There is a relative paucity of laws that deal with discrimination that goes on in the mortgage lending market. Title VII obviously doesn't cover it because it is not an employment decision. Section 1981, I suppose there is a remedy, but a lot of litigants and a lot of plaintiffs' attorneys are not well educated about Section 1981.

In my State of Alabama, we do not have any State civil rights laws at all.

So as we look at reframing our regulatory structure, one thing that does occur to me is that there is room to have a much more direct set of Federal provisions that address racial discrimination in the area of market lending.

And let me close by congratulating my friend, Rob Couch, for being here. Rob, I would have been at your event in Birmingham yesterday if we didn't have something called votes up here. But I want to welcome you to your new position, and thank you for the work you do in our community.

Thank you, Mr. Chairman.

Chairman NEY. I want to thank you, and I want to thank the panel. I think it was extremely informative. I appreciate your time and your indulgence on your trip here to the Capitol.

With that, we will convene the second panel.

Chairman NEY. Micah S. Green, President of The Bond Market Association; Mr. Cameron "Cam" Cowan, Chair of Legislative and Judicial Subcommittee, American Securitization Forum; Ms. Margot Saunders, Managing Attorney, National Consumer Law Center; Professor Kurt Eggert, Associate Professor of Law, Chapman University School of Law; Reverend William Somplatsky-Jarman, Presbyterian Church USA, on behalf of the Interfaith Center on Corporate Responsibility; and Mr. Frank Raiter, Managing Director of Standard & Poor's.

Thank you for attending, and we will start with Mr. Green.

STATEMENT OF MICAH S. GREEN, PRESIDENT, THE BOND MARKET ASSOCIATION

Mr. GREEN. Thank you very much, Mr. Chairman. And thank you for inviting The Bond Market Association to be a part of this hearing.

The Bond Market Association represents the underwriters and dealers of fixed income securities which include the securitization process. The mortgage securitization process has resulted in a $5 trillion mortgage-backed securities marketplace.

Essentially, the secondary market for any product exists after a market develops and matures. Just like in the mortgage market, the asset-backed market developed from assets that initially were all in the prime market. As the subprime lending market grew, a secondary market grew from that, to create efficiencies in that market. And as we have heard earlier, it also reduced interest rates and increased access to capital for many people.

A friend of mine asked me if it would be tough to testify at a hearing with The Bond Market Association having been quite outspoken against some of the State initiatives that have come up in the past. And I said, first of all, we don't like predatory lending.

As you have heard from many before, The Bond Market Association is in the secondary market. We are not lenders. We don't like predatory lending. And we happen to believe that it is a problem that must be dealt with credibly and responsibly.

Second, our position on this issue is about preserving access to capital for people who need it. I dare say this would be a significantly more awkward hearing for me if the title of the hearing is, Why Is the Secondary Market Cutting Off the Supply of Capital to Your Constituents Who May Simply Not Have Stellar Credit? This committee and the work of this committee for many, many years has been about ensuring access to capital, not limiting that access.

The predatory lending issue must be dealt with. As you heard from the previous panel, originators of loans have and must continue to work tirelessly to ensure lending practices are appropriate and protect people from predatory practices. You will hear from some witnesses today that believe the only way to truly inhibit predatory lending practices is to move the liability from the predatory culprit to the investor who buys a security that among the thousands of loans in that portfolio contain such loans that are claimed to have been predatorily obtained months or years earlier by the originator.

I guess I would have to agree that, as proposed by these witnesses, there is no question that it would be an effective way of limiting predatory lending, much like that of banning motor vehicles on roads to reduce speeding and other motor vehicle violations. It is a solution, but it carries with it unintended consequences, because just as a ban on motor vehicles would also make transportation and commerce generally much more difficult, the type of assignee liability supported by some would go well beyond the target of predatory lending.

It would make it far riskier for participants in the secondary market for all subprime loans. Those risks would not be precise or predictable, and would result in increases in the cost of subprime loans to borrowers in legitimate need. It could even make uneconomic the entire securitization process for these loans, given the additional capital that would have to be committed in putting those deals together.

Numerous States have attempted to get it right and have been off the mark. My written testimony discusses many of those examples, like Georgia, which was discussed earlier.

In this national marketplace, we need a national policy that will truly help address the predatory lending problem and do so in a way that minimizes the law of unintended consequences. Legislation is needed to provide an important balance of tough policy on predatory lending and a clear national policy on how the secondary market should play a role in that process.

And, in closing, Mr. Chairman, I would just add to the comments that Congressman Scott and others on the panel have talked about, financial literacy. The Bond Market Association through its foundation, The Bond Market Foundation, is very pleased to sponsor a program called tomorrowsmoney.org, which is a Web site geared toward basic financial literacy targeted to women, young people, and the Hispanic community. It talks about savings and investments, but far earlier than savings and investment, it talks about the basic building blocks of learning how to save and budget and live a normal life with financial responsibility. We have geared that program to targeted communities, and we would look forward to working with this committee in trying to help promote further financial literacy in this area.

Thank you, Mr. Chairman.

Chairman NEY. Thank you.

[The prepared statement of Micah S. Green can be found on page 153 in the appendix.]

Chairman NEY. Mr. Cowan.

STATEMENT OF CAMERON "CAM" L. COWAN, ESQ., CHAIR, LEGISLATIVE AND JUDICIAL SUBCOMMITTEE, AMERICAN SECURITIZATION FORUM

Mr. COWAN. Thank you, Chairman Ney, for holding this hearing and for the opportunity to testify today on the role and importance of securitization.

I am a partner with the law firm of Orrick, Herrington, and Sutcliffe. Within Orrick, I serve as the Managing Director of Finance Practices and am a member of the firm's executive committee. I am also a member of the American Securitization Forum's executive committee, and I chair the American Securitization Forum's Legislative and Judicial Subcommittee.

The ASF, an affiliate of the The Bond Market Association, is a broadly based professional forum of participants in the U.S. securitization market. ASF members include investors, issuers, underwriters, dealers, rating agencies, insurers, trustees, servicers, and professional advisors working on transactions involving securitizations. For the last 16 years, my law practice has focused on structured finance or securitization. My knowledge of subprime and predatory lending generally comes from the perspective of the secondary market, and my testimony today will focus on the securitization process, the growth of the industry, and the many benefits securitization brings to consumers, issuers, and investors.

Securitization is the creation and issuance of debt-like securities or bonds whose payments of interest and principal derive from cash flows generated by separate pools of assets. It has grown from a nonexistent industry in 1970 to $6.6 trillion as of the second quarter of 2003.

Financial institutions and businesses of all kinds use securitization to immediately realize the value of cash-producing assets. These are typically financial assets, such as loans, but can also be trade receivables or leases. In most cases, the originator of the assets anticipates a regular stream of payments. By pooling the assets together, the payment streams can be used to support interest and principal payments on debt securities. When assets are securitized, the originator receives the payment stream as a lump sum rather than spread out over time.

Securitized mortgages are known as mortgage-backed securities, while securitized assets—that is, nonmortgage loans, or other assets with expected payment streams—are known as asset-backed securities. By making it easier for mortgage lenders to sell their loans into the secondary market, mortgage-backed securities create efficiencies in the mortgage industry that are passed on to borrowers in the form of lower interest rates and more readily available credit. Issuers of mortgage-backed securities also benefit from a lower cost alternative to raising funds in the capital market. Investors gain, too, as mortgage-backed securities generally are a low-risk liquid investment.

Securitization reflects innovation in the financial markets at its best. Pooling assets and using the cash flows to back securities, allows originators to unlock the value of the liquid assets, and generally provides consumers lower borrowing costs at the same time.

Mortgage-backed securities and asset-backed securities offer investors an array of high-quality fixed-income products with attractive yields. The popularity of this market among issuers and investors has grown dramatically through the last 30 years. The success of the securitization industry has helped many individuals with subprime credit histories obtain credit. Securitization allows more subprime loans to be made because it provides lenders with access to capital in an efficient way for them to manage risk.

It is possible that the various State and local efforts to curb predatory lending could increase the cost to subprime borrowers and dramatically reduce the opportunity of local subprime markets to access the national capital market. Moreover, secondary market purchasers of loans, securitization vehicles, financial intermediaries, and investors are not in a position to control origination practices, loan by loan. Regulation that seeks to make a police force of these secondary market participants through unlimited or vague assignee liability will only succeed in driving them from investing in the subprime market.

The problem of predatory lending clearly needs to be addressed by legislative action, but only after careful consideration of the full range of public policy issues. The challenge is to curb predatory lending without limiting the ability of subprime borrowers to obtain loans.

The secondary markets are a tremendous success story that have helped democratize credit in this country. Well-intended, but ill-considered State and local regulation in this area could do much harm. For this reason, the American Securitization Forum respectfully urges this committee to consider Federal legislation in this area and legislation that will provide a reasonable safe harbor from assignee liability for secondary market participants.

Thank you again for this opportunity to testify today.

Chairman NEY. Thank you.

[The prepared statement of Cameron L. Cowen can be found on page 117 in the appendix.]

Chairman NEY. Ms. Saunders.

STATEMENT OF MARGOT SAUNDERS, MANAGING ATTORNEY, NATIONAL CONSUMER LAW CENTER

Ms. SAUNDERS. Mr. Chairman Ney and Ms. Waters, thank you for inviting us to testify today. I am here today on behalf of the low-income clients of the National Consumer Law Center, Consumers Union, and the National Association of Consumer Advocates.

I have a lot to say that obviously I cannot address in the 5 minutes that I have, so I would ask you to take a look at our written testimony. But I think I want to focus on a few specific points.

One is this—I think someone on the previous panel said it specifically. In the year 2003, we are not dealing with the same access to credit problems that this Congress dealt with in 1980. In 1980, when Congress passed the laws that began the deregulation of credit, there was an access to credit emergency because of high interest rates. Since that time, we have seen a continual deregulation of credit and a democratization of access to credit which has helped many homeowners to obtain homes, which has been very good. However, we have seen—we who represent low-income consumers and consumers actually believe there is too much credit.

There is especially too much home credit. This is a push market. People are too often being pushed into mortgages or actually into refinancing mortgages, not the mortgages used to buy the homes, but people are being pushed into refinancing their existing mortgages essentially for reasons that do not benefit them.

There is lots of research that I cite in my testimony that indicates that the securitization of mortgage credit, while good in bringing more money to homeowners, for home-buying purposes, has actually created an incentive to originators to fill loan securitization pools, which in turn require these originators to go out and find borrowers for the loans. These loans then are often not really benefiting the consumers, they are more benefiting the originators.

I want to point you to the chart in my testimony which shows a huge increase in the foreclosure rate in the last 20 years with a very small relative increase in the homeownership rate between—on page 7. Between the years 1980 and 2001 we have seen an increase in homeownership of 3.4 percent. That is an important increase. But we have seen an increase in foreclosures of 250 percent. This we blame on the subprime mortgage market. If you look at the number of prime loans that are going to foreclosure, it has remained essentially flat over the years. Approximately 1 out of 100 prime mortgage loans are foreclosed upon, but 8 percent, or 1 out of 12 subprime loans go to foreclosure.

There has been a lot of discussion about financial literacy, and I would ask you, look at almost any other area of regulation or lack of regulation in this country. Elizabeth Warren, Harvard law professor, pointed out the difference between the way we regulate toasters and the way we regulate mortgages. If there was a chance that a toaster sold on the market would have a 1 in 12 chance of blowing up, do you think it would be allowed to be sold? Would we say that it is adequate protection against a toaster with a 1 in 12 chance of blowing up that we give more toaster literacy training to consumers? Is that the appropriate way to protect people?

Toasters are actually far easier to use than mortgages are to understand. The loss that results from a toaster blowing up is actually probably less serious than what happens to the 12 out of 100 Americans who get subprime mortgages that go to foreclosure. That is the analogy that I would ask you to consider.

I would like to point out a couple of very important points. I don't know who exactly on this panel is pointing—pushing for unlimited assignee liability. We are not. We are pushing for some assignee liability.

I have gone through in my testimony a full explanation of the assignee liability that exists in current law now. There is already assignee liability in the secondary market. The idea of it is not new. In fact, for a holder of a loan to be able to avoid assignee liability, several hoops must be jumped through that are not at all automatic. But I researched Standard & Poor's and Fitch's statements to see what they would find to be adequate assignee liability rules. They have both said in the last month that so long as there were capped damages and the rules were clear, assignee liability was acceptable.

That is all we are asking for, capped damages and clear rules. We think the clear rules for mortgage regulation as we propose here actually would benefit everybody.

I see I am out of time, but I am happy to answer any questions.

Chairman NEY. Thank you.

[The prepared statement of Margot Saunders can be found on page 268 in the appendix.]

Chairman NEY. Mr. Eggert.

STATEMENT OF KURT EGGERT, ASSOCIATE PROFESSOR OF LAW, CHAPMAN UNIVERSITY SCHOOL OF LAW

Mr. EGGERT. Good afternoon. My name is Kurt Eggert; I am an Associate Professor of Law at Chapman University School of Law. And Chairman Ney and Ranking Member Waters, I appreciate the opportunity to come talk to you about predatory lending, its definition, causes, and cures.

First of all, definition. Some people say that we can't even define predatory lending, how can we start addressing it? Which I think is just not true. I think we can come up with a good, workable definition of predatory lending, and that definition should look at both the practices that are used against borrowers and also the results.

The practices are things like prepayment penalties, credit packing. The results are the overpriced loans and increased risk of foreclosure. So I would define predatory lending as the use of manipulative, coercive, or deceptive tactics to get borrowers to accept loans that are overpriced, given their risk characteristics and their market prices, or that leave borrowers worse off than they were before the loan, or both.

Now, a loan can leave a borrower worse off if it increases the risk that they will be foreclosed on or if, for example, a lender gets a borrower to refinance a below-market loan. And these two things should be balanced against each other so that the higher the loan price is, the less you have to see, as far as unfair or deceptive practices, to conclude that the loan is predatory.

Now, on to the causation. We have seen a huge spike in the amount of predatory lending in the 1990s at the same time that we saw the rapid growth of the securitization of subprime loans; and I think there is a direct connection between those two. If a predatory lender does not have access to the secondary markets and if they are forced to hold their own loans, it dramatically limits their ability to lend and to grow, because as they lend, they are going to have a portfolio of borrowers who are angry at them, who are not going to want to pay, and who are going to want to sue them.

If, on the other hand, they have access to the secondary markets, what the predatory lender can do is make loans, sell it on the secondary market, get the money back, and make new loans. They can churn and grow. And we saw that throughout the 1990s. You would see a new lender come on, there would be complaints against it, but it would lend more and more and more and grow dramatically, quickly, and then suddenly declare bankruptcy or leave the field.

Securitization has other problems for us, especially for subprime borrowers. It causes the most rapid creation of a holder in due course. A holder in due course is someone who can claim there is no assignee liability to me because I have jumped through all the hoops that Ms. Saunders talked about; and so most of the defenses that the borrower had to the initial lender are cut off. Securitization allows this to happen so quickly that often by the time a borrower makes their first payment their loan has already been sold, and so if there were misrepresentations made to them at the time of the loan, by the time they make the first payment they have lost their ability to sue the current holder of the note to get out of the loan.

The other thing that securitization does is that it allows thinly capitalized organizations to originate loans. You don't have to have a lot of money if you can make a loan, sell it, get the money, make a loan, sell it; and that way, if somebody does sue you, well, you don't have this big portfolio of loans that they can go against. So it allows people with not that much money who originate loans to sell them to the secondary market.

Now, defenders of securitization will say, well, securitization does lower interest and—interest rates and mortgage costs. Interestingly, there was a recent analysis by a couple of Federal Reserve Board economists that said actually the cause and effect are reversed. What they concluded was that lowered interest rates increased securitization, not the other way around.

There is even an argument that in some cases securitization may increase interest rates or mortgage costs if the securitizers aren't confident that what the originators are selling them—if they aren't confident about the credit risk of what is being sold to them. So I will treat the borrowers as if they are potential lemons, and they will demand a higher interest rate than their credit risk would require. So I don't think it is proved that securitization lowers interest rates.

So what is a cure for predatory lending? The cure is—we can't depend on regulators. By the time they step in, as well-meaning as they are, it takes them a while to find out about predatory lenders; it takes a while to develop a case and to bring an action.

Instead, I think the solution is to get the people who are on the ground, the securitizers who see all the loans come in, get them to step in and refuse to deal with predatory lenders; get the ratings agencies, the underwriters, the Wall Street bankers to say we are not going to deal with these scam lenders.

How do you do that? Well—and why would we have them do it? Because if we say predatory lending—if one of the central bases of predatory lending is overpriced loans, they can detect that. They can look at their loan pools and say, examining the loan-to-value ratios and the FICO scores, we can tell that this is a pool with overpriced loans. They have the ability to detect it in a way that the borrowers can't tell if they were being charged too much. They can also look at default rates. They can track, they can trade information on bad originators.

How do we make the securitizers do this job? The solution is assignee liability; if you say, your investors are going to pay the price if you deal in predatory loans, then the ratings agencies will make sure that they track it.

Chairman NEY. Professor, what I want to do, since you have run out of time—but it is fascinating and I have some questions on—I would like to go on to the other two panelists because we are running a little short, and then come back with questions that will pertain to assignee liability.

[The prepared statement of Kurt Eggert can be found on page 126 in the appendix.]

STATEMENT OF REV. WILLIAM SOMPLATSKY-JARMAN, PRESBYTERIAN USA, ON BEHALF OF THE INTERFAITH CENTER ON CORPORATE RESPONSIBILITY

Rev. SOMPLATSKY-JARMAN. Thank you, Mr. Chairman, distinguished members of the committee. I am very pleased to be here on behalf of the Presbyterian Church USA and other religious investors, part of the Interfaith Center on Corporate Responsibility. With me here today is Dr. John Lind of our research organization. CANICCOR has provided us with quality research into these issues for our advocacy efforts, and I am pleased that our remarks and his research will be entered into the record for your use in the future.

Presbyterian Church USA is committed to a consistency between our mission goals, our ethical values, and our investments. Through our urban and rural church networks, we are well aware of the need for access to capital in order to revitalize our communities and stabilize our neighborhoods. We are also well aware of the stories of the roadblocks and abuses, such as redlining and predatory lending. And as religious investors, we own stock in every one of the major banking and financial institutions of this country that is involved in the subprime loan market.

When CitiFinancial bought Associates First Capital, we initiated a series of meetings with CitiGroup and CitiFinancial about that acquisition. And after these discussions, along with CitiGroup's settlement with the FTC, other regulatory investigations, and the pressures from community groups, I can say today that I believe that CitiFinancial and CitiGroup has incorporated many of the better practices within the subprime industry into its regular way of doing business.

We have also met with a number of subprime lenders, Washington Mutual's Long Beach Mortgage, Chase Manhattan Mortgage, Wells Fargo, and we anticipate this year our first meetings with National City's First Franklin, Key Course, Champion Mortgage, and Lehman Brothers. We also met with a nondepository lender, Household, but now that it has been acquired by HSBC, those discussions are on hold.

So far, what we have found is that subprime lenders, particularly those that are subsidiaries of depository holding companies, largely have taken to heart the settlements in 2002 between the FTC and CitiFinancial and the settlement with 20 States' Attorneys General with Household, if they already did not follow decent practices. And, thus, we are starting to focus more on the small lenders, which are often finance companies that may be privately held or not widely held public firms.

We find that these small lenders are usually not subject to Federal supervision other than complaints filed with the FTC, and they probably represent some of the more egregious firms, such as First Alliance. Thus, the regulation of these smaller firms seems best achieved through secondary market mechanisms.

The secondary market is the more logical route because these small firms are usually not depository affiliates that can supply funding to them, and they have to sell off their originated loans on a timely basis into the secondary market in order to preserve their liquidity.

Two problems arise in the secondary market we wish to address, the issue of issuers and underwriters. First is their need to perform adequate due diligence to eliminate their liability for handling loans from fraudulent loan originators such as First Alliance, or Lehman Brothers now has a court-ordered liability of $5 million.

Second, and perhaps a more insidious case, is that of the subservicing firms. These firms buy the servicing rights, often are the more risky loans; and in buying these rights, they take on the job of dealing with loan delinquencies and foreclosures. In the case of Fairbanks Capital, the FTC has alleged that they counted on-time payments as late and therefore assessed late fees, and they started unnecessary foreclosure proceedings in order to gain additional fees.

Based upon our analysis provided by Dr. Lind of CANICCOR, we are starting a round of dialogues especially with firms that serve as both issuers and underwriters, because these firms tend to handle loans from smaller lenders. These smaller lenders often use brokers as their primary source of loan applications, and since brokers are not employees of the lender, the lower level of control over the brokers can permit predatory practices by some of them to go undetected.

In addition, these issuers and underwriters use subservicers who have no relation to the lenders, and they may then use unethical practices in handling delinquencies and foreclosures. We, however, as religious investors, believe in what we have been working with, the companies in which we own stock, to say that good policies, good practices promote more profitable companies in the future.

Thank you very much.

Chairman NEY. Thank you.

[The prepared statement of Rev. William Somplatsky-Jarman can be found on page 287 in the appendix.]

STATEMENT OF FRANK L. RAITER, MANAGING DIRECTOR, STANDARD & POOR'S

Mr. RAITER. Good afternoon, Chairman Ney, members of the subcommittee. And thank you for this opportunity to testify.

As an independent and objective commentator on credit risk, Standard & Poor's generally does not take a position on questions of public policy. Thus, while Standard & Poor's strongly supports efforts to combat predatory lending and other abusive practices by lenders, it does not take a position on what legislative and regulatory actions would best accomplish that goal.

Nevertheless, Standard & Poor's has been closely following legislative and regulatory initiatives designed to combat predatory lending in order to determine how those laws might affect its ability to rate securities backed by residential mortgage loans. Standard & Poor's appreciates the opportunity to discuss the factors it considers when evaluating the impact of antipredatory lending laws on rated transactions.

Increased access to mortgage loans has led to increased homeownership across the United States. While this growth in homeownership is positive, it has become evident that some of this increase has unfortunately occurred simultaneously with a rise in predatory lending practices. Among others, these predatory practices include the following: charging excessive interest or fees, making a loan to a borrower that is beyond the borrower's financial ability to repay, charging excessive prepayment penalties, encouraging a borrower to refinance a loan notwithstanding the lack of benefits to the borrower, and increasing interest rates upon default.

Antipredatory lending statutes are designed to protect borrowers from these unfair, abusive, and deceptive lending practices, and Standard & Poor's strongly supports efforts to eliminate predatory lending. However, in its role as a provider of opinions on credit risk, Standard & Poor's must evaluate the impact of these statutes on the return to investors in mortgage-backed securities. Indeed, given the expansion of individual investment in securities through various retirement and pension plans, these investors might actually be the very same borrowers the statutes are intended to protect.

Standard & Poor's has determined that some of these statutes may have the negative effect of reducing the availability of funds to pay these investors. This reduction could occur if an antipredatory lending statute imposes liabilities on purchasers or assignees of mortgage loans simply because they hold loans that violate a statute even if they did not themselves engage in predatory lending practices.

In performing this evaluation of antipredatory lending laws, the two most important factors that Standard & Poor's considers are whether an antipredatory lending statute provides for this assignee liability, and, if so, what penalties the statute imposes on assignees for holding predatory loans.

If Standard & Poor's determines that no assignee liability exists, Standard & Poor's will generally permit loans covered by the statute to be included in rated transactions without any further consideration or restriction. If, on the other hand, a loan does permit assignee liability, Standard & Poor's will evaluate the penalties under the statute.

If damages imposed on purchasers are not limited to a determinable dollar amount, that is, the damages are not capped, Standard & Poor's will not be able to size the potential liability to its credit analysis. Therefore, these loans cannot be included in rated transactions. If, on the other hand, monetary damages are capped, Standard & Poor's will be able to size in its credit analysis the potential monetary impact on violations of the statute.

Standard & Poor's looks to all types of potential monetary damages including statutory, actual, and punitive damages. It should be noted, however, that even if capped damages can be sized, it may not be economical for a lender to make sure loans, if the credits support the Standard and Poor's required, equals or exceeds the monetary value of the loan. For example, if a statute provides for punitive damages, even if these damages are capped, the amount of the damages may well exceed the loan value.

In making these determinations, above all, Standard & Poor's looks for clarity in a statute. Specifically, Standard & Poor's looks for statutory language that clearly sets forth what constitutes a violation, which parties may be liable under the statute and, as noted, whether any monetary liability is limited to a determinable dollar amount. Absent clarity on these issues, in order to best protect investors in rated securities, Standard & Poor's must adopt a conservative interpretation of an antipredatory lending statute, and may in instances in which liability is not clearly limited exclude mortgages from a transaction that it rates.

In offering these comments today, Standard & Poor's reiterates to the honorable members of the subcommittee that as a public policy matter, Standard & Poor's supports legislation that attempts to curb predatory and abusive lending practices. Standard & Poor's also notes, however, that its role is to evaluate the credit risks to investors associated with an antipredatory lending legislation and not to recommend public policy.

This concludes my testimony on behalf of Standard & Poor's Ratings Services. I will be happy to answer any questions.

[The prepared statement of Frank L. Raiter can be found on page 227 in the appendix.]

Chairman NEY. I want to thank the panel.

Before we get to the questions, Congressman Kanjorski has joined us and has not had an opportunity to ask questions yet, so I will yield to the Congressman.

Mr. KANJORSKI. Thank you, Mr. Chairman.

I happened to listen to all the testimony, and this is a highly emotionally charged issue just by—the nature of the language we use sort of poisons the well. Is there anyone here at the table that feels that there isn't a need in our society to accomplish subprime lending?

So I gather no one is opposed to subprime lending.

What we are attempting to get at is how it can be facilitated in the most protective way for the consumer, for the investor or lender if it is securitized, and to rid the marketplace of unscrupulous actors. Is that substantially the issue that is before the committee, that you think that Congress should move on?

This is an issue that lends itself to great demagoguery from the standpoint that, you know, to scream against predatory lenders is always popular with the constituents. The word itself is so emotionally charged. However, I have concluded that there is a need for national legislation and potentially national standards if we are going to move into this field, and that the effort has to be made by this committee, not only the subcommittee but the committee as a whole and then eventually the Congress, to put a framework together that this should be done.

So in that light, Mr. Chairman, I would suggest that we take the advantage of some of the statements made by some of the members of the committee today, particularly during the first panel, to think towards putting together a working group to really work through these various identified issues that I think can be met to everyone's advantage; that is, remove the unscrupulous from the field to make certain that securitization can be made to the advantage of reducing interest rates to the lender that has to resort to that area of lending, and to meet the challenges of good ethics, good morals, as well as good law.

Has anyone worked on their ideal statute or model? Yes.

Ms. SAUNDERS. Yes, Mr. Kanjorski. I am Margot Saunders with the National Consumer Law Center.

I was very involved in the passage of HOEPA; I was one of the authors of the AARP Self-Help NCLC model bill that has been passed in some form in a number of States; and I have worked with both Senator Sarbanes and Mr. LaFalce on their bills. And I propose in this testimony a new way, a streamlined way of addressing the problem that I believe, while simpler, would reduce many of the problems without much—without causing many of the difficulties.

Mr. KANJORSKI. Are you in favor of a national standard?

Ms. SAUNDERS. I am in favor of a national standard, but not one that preempts. I think if you look at all of our consumer protection laws, starting with the Truth in Lending Act, the Fair Debt Collection Practices Act, the Equal Credit Opportunity Act, all of the laws with the single exception of the Fair Credit Reporting Act, do preempt inconsistent State laws to the extent that the State laws are less protective of the consumer. They do not preempt the State's ability to add additional protections to that floor, and that is where I would advocate that you all start.

I would point out that most States would not have a need to add on additional consumer protections if the floor were adequate. Just as very, very few States have come up with their own truth in lending acts because the Federal Truth in Lending Act is comprehensive, it would be a similar nonquestion if the floor that was established by Congress was sufficient, and you would end up actually satisfying both sides of this debate. You would solve predatory lending and without creating the problem caused by a broad preemption of State laws.

Mr. KANJORSKI. Don't we negatively impact on the advantage of a national market and national rates if we start to have a construct where every State decides to add on their particular brand of what should be done?

And, you know, I am very cognizant of the fact that this is an emotionally charged political issue. A State legislator just loves to wave his amendment or bill saying, I am saving all you poor people out there because I have put something stricter than the Federal Government's standard in place.

Ms. SAUNDERS. But you can do that. You can take the North Carolina standard or another State standard that is very good and say, This is going to be the Federal floor. Any State that has a law that is not as good as this is preemptive.

Mr. KANJORSKI. But you are allowing the States to go beyond?

Ms. SAUNDERS. Yes. But I would point out that if that floor is high enough, very, very few States will do that and it won't be necessary; just as very, very few States have actually passed laws that are more protective than the Truth in Lending Act, and it is because it is not necessary.

Mr. KANJORSKI. On the fair credit reporting, wasn't that the major issue that we faced, that in order to create a national standard we had to preempt State's rights and did so because it was determined by the Congress it was more important to have a workable statute that provided the best information and flow of information than to allow each State to make its own formula?

Ms. SAUNDERS. I am sure that is why you pushed for it, sir, but I can say that we were never in favor of it.

Mr. KANJORSKI. Your feeling is, Congress made a fundamental error?

Ms. SAUNDERS. Well, the bill hasn't passed yet, but I think that Congress is about to make a fundamental error, yes, sir.

Mr. KANJORSKI. Yes?

Mr. GREEN. Congressman, I would just simply agree with what you are saying. A floor is not a national standard if it is not preemptive. The fact is, we have been working with numerous State legislatures and, in fact, even city councils.

For example, in New York City, when they couldn't really amend the actual lending law, they prohibited any firm that was involved in securitization from doing municipal bond business with the City of New York if these standards weren't met. So the fact is, you are going to have numerous pieces of legislation coming at it even if you set a floor because of that demagoguery that naturally takes place.

This is a national marketplace. We need a national standard to allow the marketplace to grow and to clean it up.

Mr. KANJORSKI. All right.

Reverend, I was going to make a comment that I didn't know whether God was on one side of this issue or not, but that wouldn't be the right comment to make, so I won't.

But you obviously do exercise your influence on lending authorities by virtue of your investments, and that is sort of a democratic process. You vote with your dollars. There is nothing wrong with that.

But do you feel also that we are capable of having a national standard that is fair to everyone and particularly protective of the consumer and rids the field of unscrupulous actors, but on the other hand urges efficiency and effectiveness in subprime lending?

Chairman NEY. I will caution, we are running out of time, because the next hearing has to come in, but if you would like to answer.

Rev. SOMPLATSKY-JARMAN. Well, I will defer the sermon and try to answer the question.

Yes, I do believe that there is the capacity to come up with standards by which the industry can weed out the predatory lenders and still maintain the positive aspects of the subprime industry.

What we have found in working with companies is that, by and large, the vast majority want to do the right thing. They are ethical people who care about what happens in the communities in which they do business. What is necessary to happen is to weed out those people who do not share that common value, and I believe that there are ways that that can be done.

And we want to just simply offer the fact that investors are also concerned about this, and we can play a role in helping to craft it and to see to it that it is followed. Thank you.

Mr. KANJORSKI. Thank you.

Mr. Chairman, may I reiterate again that I think this is a very important issue. We should address it. And I will do everything I can to assist you and the rest of the committee in coming to a positive conclusion.

Chairman NEY. I appreciate the gentleman's comments, and I am very amenable to a working group. And the one thing I want to say about that is, this, I know, is a very emotional subject. Congressman Lucas knows that; he is on the bill as the prime person helping this. But I think it is a subject that needs to be discussed, needs to have thorough vetting. And, again, I know it is emotional.

And then some people say, why do you even talk about this? Well, you know, it needs to be discussed. I am sorry that we are out of time, but I am amenable to a working group.

And, again, they have got another hearing in here, but I think the actual liability—and both Ms. Saunders and Professor Eggert, I think that is an area that I would like to follow up with you. I mean, we have been on a couple of roundtables that we had some discussions, I know, but that is where you look at the fact that somebody has to be responsible if something was done wrong; and do you go to the source that created it, even if it came down the pike, and go to the source that created the problem versus, you know, the entity it was passed to, whether it was Fannie or Freddie or whoever? I think that is one of the issues, because Georgia, according to what I understand, they said, Look, if it is all going to be passed to us and we didn't have any responsibility in creating that bad situation, we are just not going to be here.

Do you want to comment on that?

Mr. EGGERT. Yes.

First of all, I think you have two innocent parties, or you have the homeowner and the assignee. But between those two, I think the assignee—the secondary market is much, much more able to stop predatory lending. And so between those two, if you have to assign the risk of this harm, I think you have to assign it to the secondary market, because they can stop predatory lenders or at least slow them down to a great extent.

But the second thing I would like to point out is, if you read the testimony of Mr. Raiter—I hope I am pronouncing your name correctly—from Standard & Poor's, what Standard & Poor's position is, assignee liability doesn't keep us from securitizing loans. As long as it is capped and it is clear, we can securitize.

And so my position is, assignee liability, I think, has to be a part of any attack on predatory lending, and it should be drafted so it is capped and clear so the ratings agencies know what they are dealing with, they can rate it, and they can sell it. And if you do that, then the securitizers will be part of the effort to stop predatory lending.

The other interesting thing of this testimony is, it says the ratings agency, once they see there is assignee liability, the way they will react is, they will have greater scrutiny of originators to see if they are engaging in predatory lending and to see if they are creditworthy.

In other words, the ratings agencies are telling us that if you include some assignee liability, capped and clear, they will do this job of limiting predatory lending and making sure that when borrowers do have to sue, there is a lender there with significant assets so the borrower can sue the lender, the secondary market can force the lender to buy back the loan, we don't have to worry about the assignees, and they are dealing directly with the person who scammed them.

Mr. NEY. [Presiding] Are there any additional questions?

I just wanted to also make one comment because Ms. Saunders raises a very interesting statement about the spending. And, you know, when I was a kid, if you made a long distance phone call, someone had better be passed away, or you might be in jeopardy of coming within an inch of your life. You just didn't do things that you couldn't pay for if there was no reason for it.

I think even beyond predatory lending—and we have got to go after the predatory lenders, but there is a whole barrage in this country of buy this, buy that, things that are mailed. In a free country, some of those things you can't stop. You have got to make sure that they are responsible. But there is a whole change in 20 years as a culture, and not just affecting poor people. I think that a lot of people climbed up that ladder to middle class and went right back down because they got in so much debt.

And this is—it is almost endemic in some ways, and some of it may not be illegal at all. It is a way of life now in the United States, and it is a visual bombarding.

But I think, too, and said this a long time ago, that I come from an education, teacher background. But I just think somewhere along the line, the school systems, too—not to hang this on the schools, but you have got to be able to get to young people somewhere and tell them how to balance a checkbook and warn them, as I have done with my own children.

So, I mean, there is an endemic problem. I am not sure that some of it is completely intentional as much as it is just the whole psyche that people are into.

When I was a kid you couldn't have a credit card. But it is a free country, so we are going to have credit cards.

But you raise an interesting scenario.

With that, I want to thank everyone. Thank you, gentlemen, for your comments. We will work with you. And we need to clear the room to prepare for the next hearing. Thank you very much to the panel.

[Whereupon, at 2:09 p.m., the subcommittee was adjourned.]

A P P E N D I X

November 5, 2003

OPENING STATEMENT OF CHAIRMAN SPENCER BACHUS
"PROTECTING HOMEOWNERS: PREVENTING ABUSIVE LENDING WHILE PRESERVING ACCESS TO CREDIT"
NOVEMBER 5, 2003

Thank you, Chairman Ney for convening this joint hearing of our two subcommittees to review issues related to the subprime mortgage lending industry in the United States. This hearing, which is titled "Protecting Homeowners: Preventing Abusive Lending While Preserving Access to Credit" will focus on ways to eliminate abusive lending practices in the subprime lending market while preserving and promoting affordable lending to millions of Americans. This is an issue of critical importance to consumers as well as the financial services industry, and I believe this hearing is a timely one.

Over the last decade or so, with low interest rates, a competitive marketplace, and various government policies encouraging homeownership, a record number of Americans have had the opportunity to purchase homes. A large number of these new homeowners have enjoyed one of the many benefits of homeownership -- using the equity in their homes for home improvements, family emergencies, debt consolidation, etc. Many of these consumers were able to purchase and use the equity in their homes because of the subprime lending market which provides millions of Americans with credit that they may not have otherwise been able to obtain.

Many borrowers are unable to qualify for the lowest mortgage rate available in the "prime" market — also known as the "conventional" or "conforming" market — because they have less than perfect credit or cannot meet some of the tougher underwriting requirements of the prime market. These borrowers, who generally are considered as posing higher risks, rely on the subprime market which offers more customized mortgage products to meet customers' varying credit needs and situations. Subprime borrowers pay higher rates and servicing costs to offset their greater risk.

Nationally, subprime mortgage originations have skyrocketed since the early 1990s. Finance companies, non-bank mortgage companies and to a lesser extent commercial banks have become active players in this area. In 1994, just $34 billion in subprime mortgages were originated, compared with over $213 billion in 2002. The proportion of subprime loans compared with all home loans also rose dramatically. In 1994, subprime mortgages represented 5 percent of overall mortgage originations in the U.S. By 2002, the share had risen to 8.6 percent.

Unfortunately, the increase in subprime lending has in some instances increased abusive lending practices that have been targeted at more vulnerable populations, i.e. minorities and the elderly. These abusive practices have become known as "predatory lending." Predatory loan features include, excessively high interest rates and fees, balloon payments, high loan-to-value ratios, excessive prepayment penalties, loan flippings, loan steering, mandatory arbitration, and unnecessary credit life insurance. Predatory lending has destroyed the dream of homeownership for many families while leaving behind devastated communities. I hope today that we will move a step forward in developing ways to put an end to these harmful and deceptive practices while continuing to preserve and promote access for consumers to affordable credit.

In closing, I want to thank Chairman Ney and Congressman Ken Lucas for their tireless efforts on this issue over the past year. They are passionate about coming up with solutions and deserve a great deal of credit for all of their work on H.R. 833, the Responsible Lending Act. I also want to commend Congressman David Scott for his work on H.R. 1865, the Prevention of

Predatory Lending through Education Act. I look forward to working with Chairman Ney, Congressman Lucas, Congressman Scott and my other colleagues as we continue to examine this complicated issue.

I yield back the balance of my time.

November 5, 2003

Opening Statement by Congressman Paul E. Gillmor
House Financial Services Committee
Subcommittee on Housing and Community Opportunity
Subcommittee on Financial Institutions and Consumer Credit
Joint Hearing entitled, "Protecting Homeowners: Preventing Abusive Lending While Preserving Access to Credit"

I would like to thank our Subcommittee Chairmen for calling this important hearing and allowing us the opportunity to discuss issues related to the subprime mortgage lending market. Since the early 1990s the subprime market has greatly expanded with just $34 billion in subprime mortgages originated in 1994 and $213 billion in 2002.

The subprime market is compromised of millions of Americans with less than perfect credit or that cannot meet some of the tougher underwriting requirements of the prime market for reasons such as inadequate income documentation, limited down payment or cash reserves, or the desire to take more cash out in a refinancing than conventional loans allow. These borrowers rely on subprime lenders for access to the mortgage market.

While subprime lending has increased access to credit for many worthy Americans it has also, in some cases, enabled vulnerable populations to be targeted by abusive or "predatory" lenders. In response to such practices many states and localities have enacted "predatory lending" laws requiring new consumer disclosures, prohibiting certain terms, and creating new legal protections for borrowers who are victims of abusive lending practices.

In my home state of Ohio, the city of Cleveland passed a law restricting high loan rates and other subprime practices intended to prohibit "predatory" activities. However, as was detailed in a recent Cleveland Plain Dealer article, this law only served to drive lenders out of Cleveland during the 14 months before it was found unconstitutional. Residents who had less than perfect credit found it almost impossible to find a home loan in the city of Cleveland.

I am happy to be an original cosponsor of HR 833, the Responsible Lending Act of 2003, legislation to establish a federal standard to combat unfair and deceptive practices in the high-cost mortgage market, establish a consumer mortgage protection board, and establish licensing and minimum standards for mortgage brokers. Establishing a balanced federal standard to combat "predatory" lending practices would allow us to address problems in the market while doing just what the title of this hearing states, "preserving [consumer] access to credit."

Thank you again, Mr. Chairman, for calling this important hearing and I hope it is only the first of many on this issue.

OPENING REMARKS OF THE HONORABLE RUBÉN HINOJOSA
HOUSE FINANCIAL SERVICES COMMITTEE
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
SUBCOMMITTEE ON HOUSING
"PROTECTING HOMEOWNERS: PREVENTING ABUSIVE LENDING WHILE PRESERVING ACCESS TO CREDIT"
NOVEMBER 5, 2003

Chairmen Ney and Chairman Bachus, Ranking Member Waters and Ranking Member Sanders,

I want to thank you for calling this joint hearing on the subprime mortgage lending industry in the United States. I want to thank you, but I also want to let you know that this is a difficult issue for me.

I represent a district in Texas comprised mostly of Mexican Americans. A district that is one of the poorest in the country and that suffers from a staggering 13% unemployment rate. I hasten to add that the unemployment rate was 21% when I first took office, and I am proud to have played a role in reducing that rate substantially.

I tell you this because my constituents -- based on their ethnicity and the poverty rate in my district -- statistically are the recipients of subprime loans. While they tend to make less money than most of their fellow citizens around this great country, they tend to have to pay more for their mortgages due to higher fees, higher interest rates, or closing costs.

So, we are here today to discuss possible solutions, both in the loan origination process and the secondary market for subprime mortgage loans, to eliminate abusive mortgage lending practices. I think that all of us on the Committee likely agree that loan flipping rules need to be tightened to ensure that mortgages are not refinanced to a point where almost all the equity is stripped from the house. And, I think that we can all also agree that assignee liability must be adjusted as necessary.

One of the more difficult issues that we need to address today is the issue of preemption. Should we preempt state laws addressing subprime lending? Should we let the Office of the Comptroller of the Currency, the Office of Thrift Supervision and the National Credit Union Administration decide the issue? Or, should we let the issue be resolved by the judicial branch?

I personally want everyone on this Committee and in this room to know how important this issue is to me and to my community. Let me assure you at this point that I understand the difference between a subprime and a predatory lender. The Hispanic Community has been targeted and significantly wounded in the past by predatory lenders. However, these lenders have paid their fines, and they are trying to make amends.

Chairman Ney and Chairman Bachus, as we move forward on the issue of subprime lending, I hope we can continue to work on a bipartisan basis as you have allowed us to do today by having an equal number of witnesses selected by the Majority and by the Minority on each panel. It gives me a great feeling to know that both sides of the aisle have been given an equal say on the makeup and direction of this hearing.

With that, I note that I look forward to the testimony of today's witnesses, and I yield back the balance of my time.

November 5, 2003

Hearing Entitled "Protecting Homeowners: Preventing Abusive Lending While Preserving Access to Credit" Before the House Financial Services Subcommittee on Financial Institutions and Consumer Credit and the Subcommittee on Housing and Community Opportunity.

Prepared Testimony of George Brown,
Senior Vice President, Self-Help,
Spokesperson, Coalition for Responsible Lending

Mr. Chairman and members of the Committee, thank you for holding this important hearing to examine the problem of predatory mortgage lending and for allowing me to testify before you today. I am proud to be representing both Self-Help and the Coalition for Responsible Lending.

Although I am relatively new to Self-Help, which opened an office here in Washington this year, I have many years of experience in community and economic development. Before joining Self-Help, I founded and led the Far SW-SE Community Development Corporation, which raised almost $2 million of equity for the revitalization of a commercial strip in the District of Columbia community this CDC serves. I have also held government posts, serving as the District's Deputy Mayor for Economic Development and, earlier, as Associate Deputy Assistant Secretary for Neighborhoods with the U.S. Department of Housing and Urban Development. Many years ago, I worked with Bank of America as it developed its community reinvestment program. I speak on behalf of Self-Help and the Coalition for Responsible Lending, but also with deep personal conviction that predatory lending devastates communities and with great certainty that Self-Help's and the Coalition's approaches to the problem are workable and fair.

As a community development financial institution—consisting of a credit union and a nonprofit loan fund—Self-Help is dedicated to helping low-wealth borrowers buy homes, build businesses, and strengthen community resources.[1] Self-Help has provided over $2.6 billion in financing in 48 states since its founding in 1980. Through our loans, we have created or maintained approximately 17,500 jobs, 18,775 child care slots, and 8,000 public charter school spaces. We have also enabled more than 33,400 families to become homeowners for the first time. Because we seek to serve those who have traditionally been denied access to credit, our loans go disproportionately to women, African Americans, Latinos, and rural borrowers. Also, because we lend only to borrowers who cannot access conventional prime home loans, we have a lot in common with subprime lenders. Despite the claims of many in the industry that our borrowers are too risky to serve (or too risky to serve without practices we consider abusive), our

[1] Self-Help has created an affiliate, the Center for Responsible Lending, to serve as a national research and resource for policymakers and community leaders dedicated to countering predatory lending.

overall loan loss rate is less than one-half of one percent per year, and our assets have grown to over $1 billion.

The Coalition for Responsible Lending represents over three million people through eighty organizations, as well as the CEOs of 120 financial institutions. The Coalition was formed in response to the large number of abusive home loans that threatened the most vulnerable members of North Carolina communities. In 1999, the Coalition spearheaded an effort to enact market-based, common sense state legislation that would protect borrowers from predatory lending practices.

In my comments today, I will address three questions. What is the nature of the predatory lending problem? How effective have state efforts, particularly the North Carolina law, been at addressing predatory lending? Finally, how can states and the federal government best work together to deal with this pernicious issue? Before going on at greater length, I'd like to share the short answers that provide direction for Self-Help and the Coalition.

First, we recognize that predatory lending is a widespread problem, one we estimate is costing U.S. families $9.1 billion each year. We know from experience that predatory lenders primarily use exorbitant and anti-competitive fees to rob families of the home equity wealth that could otherwise be used to send children to college, start small businesses, weather crises such as unanticipated medical expenses, and enjoy some measure of security in old age.

Second, we believe that market-based solutions will work best. The North Carolina legislation <u>does</u> <u>not</u> cap interest rates beyond the limits established in the federal Home Ownership and Equity Protection Act of 1994 ("HOEPA"). Rather, it encourages lenders to limit fees. In this way, credit risk is reflected in rates, and loan balances do not become inflated by the financing of fees. We came to this solution out of frustration at our inability to help borrowers who were locked into fee-laden loans.

The problem of excessive fees is two-fold: the fees seem painless at closing and they are forever. They are deceptively costless to many borrowers because when the borrower "pays" them at closing, he or she does not feel the pain of counting out thousands of dollars in cash. The borrower parts with the money only later, when the loan is paid off and the equity remaining in his or her home is reduced by the amount of fees owed. In addition, the fees are forever because, even if another lender refinances a family just one week later, the borrower's wealth is still permanently stripped away.

In short, abusive loans were stripping equity from low-wealth families faster than we were helping them become homeowners in the first place. Consequently, the North Carolina law prohibits or discourages unfair and abusive fees and prohibits the "flipping" of loans for fee generating purposes.

Research shows that North Carolina's approach is working. In the great spirit of cooperative federalism, other states are learning from and improving upon our example.

Moreover, North Carolina is learning from the efforts in other states. Following the lead of several other states, our legislature amended the North Carolina law this year to bring open-end loans within its scope.

Finally, we believe the federal government is facing a choice to either continue its partnership with states in the effort to protect the hard-earned wealth of American families or destroy the ability of states to protect their homeowners. We believe that it is crucial that the current partnership be maintained. While the Federal government initially set the floor for home loan protections in the Home Ownership and Equity Protection Act of 1994 (HOEPA), states have built upon that framework. But, perhaps more impressively, federal agencies have learned from states and incorporated new higher standards into the federal floor. Indeed, echoing state actions, the Federal Reserve Board has addressed the harmful practice of financing credit insurance within the rubric of HOEPA and the Office of Thrift Supervision has restored states' ability to regulate prepayment penalties on home loans. These are prime examples of how state and federal efforts can be complementary. At the same time, while a national floor of consumer protections could help many, federal preemption of state laws—the creation of a ceiling above which states may not protect their own citizens--would needlessly cut off states' pioneering efforts to address predatory lending. The ultimate burden of such a loss would be borne by U.S. homeowners left unprotected from predatory lending abuses.

I. PREDATORY LENDING IS PERVASIVE, (USUALLY) PERFECTLY LEGAL, AND DEVASTATING TO FAMILIES AND COMMUNITIES.

Subprime lending generally describes loans made to individuals who do not meet the criteria for mainstream (also called "prime") loans. Lending in the subprime market has exploded in the past decade[2], increasing from $34 billion in 1994 to $213 billion in 2002.[3] While by no means are all subprime loans predatory, almost all predatory loans are subprime. As a result of the growth of subprime lending, the pressing issue today is no longer the availability of credit in America's communities. Rather, the debate has shifted to the terms on which credit is offered.

Predatory lending is a term used to describe a set of abusive home lending practices that deprive homeowners of hard-earned equity. The combination of tremendous growth in subprime lending, the lack of standards for this rapidly growing

[2] The rise in subprime lending far exceeds the rise in homeownership by those in the subprime market, as most subprime loans are made to refinance debt. Some subprime lenders actively market refinancing to families who have significant equity in their homes; some market new loans to families who own their homes outright. Borrowers are encouraged to put their driveways and living rooms at risk in order to buy or hold onto cars and furniture.

[3] The substantial growth in the subprime market has had a disproportionate impact on low-income homeowners, particularly members of minority groups. After analyzing almost one million mortgages reported to HMDA in 1998, HUD found that subprime loans are five times more likely in black neighborhoods than in white neighborhoods. Homeowners in high-income black neighborhoods are twice as likely as homeowners in low-income white neighborhoods to have subprime loans. "Unequal Burden: Income & Racial Disparities in Subprime Lending in America," U.S. Department of Housing and Urban Development (April 2000).

industry, and subprime borrowers' frequent lack of financial sophistication has created an environment ripe for abuse. The headlines from business pages around the country speak of those who have taken advantage of this environment. For example, in August 2003, Household International, Inc. agreed to settle claims of predatory lending practices brought by state attorneys general and financial regulators. The monetary settlement was $484 million nationwide.

While large, collaborative enforcement actions have been met with well-deserved cheers, we cannot be complacent. Cases such as Household are both remarkable and, relative to the scope of the predatory lending problem and the human toll it exacts, insufficient. (Certainly, receiving modest monetary relief of approximately $1,500 per loan years after losing one's home is better than nothing—but such an outcome does not exactly represent an ideal solution.) Current federal law does not address many widespread abuses, such as fee-packed refinancing loans that offer no benefit to the borrower (flipping) and exorbitant prepayment penalties for repaying the balance of a subprime home loan early—and state laws have just begun to address these issues. Indeed, many victims of predatory lending lose equity in their homes every day without the slightest public attention to their plight. Moreover, even where laws protect homeowners, many subprime lenders have sought to preclude private legal action through pre-dispute mandatory arbitration clauses designed to frustrate such efforts.

The stories of individuals who have been callously preyed upon by predatory lenders could fill volumes. For instance, a borrower from Wilmington, North Carolina, an African American widow who worked as an elementary school janitor, has lost title to her home to a predatory lender. Her husband had bought a house with a low-rate Veterans Affairs loan with generous forgiveness features. He later died of complications from injuries sustained in Vietnam. In 1997, Chase Mortgage Brokers (no relation to JP Morgan Chase) refinanced this woman's loan at 13 percent interest, charging 10 percent in fees. Six months later, the same company flipped her, refinancing the loan and accumulating more fees, which then totaled $17,000. In 1999, the woman faced foreclosure. She now rents the same house from the foreclosure buyer at above-market rent because it's her daughter's only connection to her father. I wish I could tell you that this story is an isolated example, but we have seen the dynamic play out time and time again—and the United States Departments of Treasury and Housing and Urban Development have documented these abuses in a joint report.[4]

Because predatory lenders are known to target certain neighborhoods, the odds are good that one victim of predatory lending lives down the street or around the corner from another. In this way, whole communities are affected, especially when foreclosures become rampant. For instance, according to the Mortgage Bankers Association, nearly 16 percent of Ohio's subprime loans were in foreclosure earlier this year. This was thirteen times the rate of foreclosure in conventional loans.[5] While we might expect

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[4] U.S. Department of Housing and Urban Development & U.S Department of the Treasury, "Curbing Predatory Lending" (June 2000) (available at: http://www.hud.gov/library/bookshelf18/pressrel/treasrpt.pdf).

[5] *See*, "Pace Quickens on Home Foreclosures in Ohio", The Columbus Dispatch (March 25, 2003).

some elevation of default rates in the subprime market, the statistics documenting Self-Help's experience with lending to borrowers with "credit risks" (including our loss rate of no more than 0.5 percent per year) suggest that foreclosures in the subprime market cannot be explained solely by borrower behavior. Rather, we must recognize that abusive lending pushes borrowers past their limits. In fact, we estimated that predatory lending costs American families $9.1 billion each year in lost homeowner equity, back-end penalties, and excess interest paid.[6]

II. STATE EFFORTS ARE BEGINNING TO REDUCE PREDATORY LENDING WITHOUT REDUCING ACCESS TO CREDIT.

A. The North Carolina legislature was the first to adopt an anti-predatory lending bill.

As I have stated, the Coalition for Responsible Lending was formed about five years ago to respond to the prevalence of predatory lending in North Carolina. Ultimately, the Coalition worked with associations representing the state's large banks, community banks, mortgage bankers, credit unions, mortgage brokers, and realtors to support a moderate bill that passed both legislative chambers nearly unanimously. In 2001, the North Carolina General Assembly, with the endorsement of the banking industry, passed companion legislation to license mortgage brokers and to spell out their affirmative duties. During the 2003 legislative session, the North Carolina legislature demonstrated its continuing support for the 1999 and 2001 reforms by extending their reach to open-end loans, closing what may have become a significant loophole. Clearly, state legislators view the North Carolina law as a great success.

From the beginning, Coalition members all agreed on two principles. First, we would not rely on disclosures. In the blizzard of paper generated for a home loan closing, even lawyers can lose track of what they are signing. Most college graduates probably do not understand terms such as discount rates, home equity, net present value, and annual percentage rate. In addition, 22 percent of the adult American population is functionally illiterate and therefore unable to read disclosures independently. Disclosures often offer nothing more than a defense for unscrupulous lenders.

Second, we would not ration credit by attempting to cap interest rates. We believe in risk-based pricing; in fact, Self-Help has engaged in it since we started making subprime loans almost 20 years ago. Loans with higher risk should bear an appropriately higher interest rate to compensate lenders for this risk. We believe, however, that the risk should primarily be paid for through higher interest rates rather than fees. Barring a prepayment penalty, a subsequent lender can always refinance a borrower out of a loan that no longer reflects that borrower's risk, assuming it ever did. However, no one can rescue a borrower from a loan that has been inflated through the financing of exorbitant fees.

[6] Stein, Eric. "Quantifying the Economic Cost of Predatory Lending", Coalition for Responsible Lending (2001) (available at http://www.predatorylending.org/pdfs/Quant10-01.PDF).

From these principles came a fairly simple solution: deter exorbitant fees and encourage lenders to garner compensation in interest rates, over which lenders can compete to arrive at a price that is a true reflection of risk. Therefore, the North Carolina law prohibits the most blatantly abusive practices (all of which involve the accumulation of fees) and establishes special protections for borrowers entering into "high-cost" loans. Practices that are prohibited across-the-board include the selling of financed credit insurance; penalizing early repayment of a first-lien home loan of less than $150,000; and "flipping," or refinancing a loan primarily for fee generation without providing the borrower with a "reasonable tangible net benefit."[7] For loans in the high-cost category, the law prohibits balloon payments and negative amortization, both of which are used to obscure the cost of equity-stripping fees. (Monthly payments are kept low, but a large payment is owed at the end of the loan's term (balloon) or the payments are not reducing the loan balance (negative amortization).)

The law provides other protections as well. Special attention is paid to identifying the fees that count toward categorizing a loan as "high-cost" in the first place. Furthermore, high-cost home lenders must look beyond the value of the collateral used to secure a loan when assessing borrowers' ability to repay. Because financed fees are often invisible fees, lenders may not finance fees in high-cost loans. (This provision was meant to encourage lenders to reflect risk in interest rates rather than fees, in keeping with our generally agreed-upon principles.) In an effort that has been endorsed by the North Carolina Housing Finance Agency,[8] counseling is required before a borrower enters a high-cost loan.[9] Finally, legislators later adopted the North Carolina Mortgage Lending Act, which has allowed state regulators to remove unscrupulous mortgage lenders from the system entirely.

A more specific explanations of the practices regulated in North Carolina may be of interest:

1. **Single-premium credit insurance**. Credit life insurance is paid by the borrower to repay the lender in the event the borrower dies. When paid for up-front, this insurance does nothing more than strip equity from

[7] The tangible net benefit standard is similar to flexible standards applied in other financial industry contexts. For example, the doctrine of suitability has been applied by the securities industry since the 1930s and has since been adopted by the commodities and insurance industries. Like the North Carolina flipping standard, suitability standards are intentionally broad and adaptable to the wide range of fact patterns giving rise to the abuse, allowing industry flexibility to develop compliance solutions that fit their customer base. See Kathleen C. Engel and Patricia A. McCoy, A Tale of Three Markets: The Law and Economics of Predatory Lending, 80 Tex. L. Rev. 1255, 1321-22 (2002) (the paper can be found in its entirety at http://www.law.csuohio.edu/handbook/engel.html). For example, Rule 2310 of the NASD's Rules of Fair Practice sets a broad "reasonable grounds" and "reasonable efforts" standard in determining the suitability of a broker's recommendation to a customer and puts the obligation on the broker or company to evaluate the transaction. Id.

[8] N.C. Housing Finance Agency, A. Robert Kucab letter to Governor Roy Barnes (February 26, 2002) (available on request).

[9] This provision is similar to Congressional standards applied to reverse mortgage transactions and Community Reinvestment Act loan products developed by lenders across the nation.

homeowners.[10] After North Carolina banned this practice, the industry largely eliminated single-premium credit insurance.

2. **Charging fees greater than 5 percent of the loan amount**. Conventional borrowers generally pay, at most, a 1 percent origination fee. The North Carolina law sets a fee threshold for "high-cost" loans at 5 percent. Because these loans should be exceedingly rare, the law provides a number of incentives for lenders to garner revenues in rates rather than fees.[11]

3. **Charging prepayment penalties on subprime loans**. Prepayment penalties trap borrowers in high-rate loans, often leading to foreclosure and bankruptcy. Prepayment penalties prevent borrowers from using the subprime market as a bridge to conventional financing as the borrowers' credit improves. While prepayment penalties are almost unheard of in the conventional market, a large majority of subprime loans contain these terms.

4. **Flipping borrowers through fee-loaded refinancings**. Abusive lenders refinance subprime loans over and over, each time charging fees that reduce home equity. Some lenders set borrowers up for refinancing by selling them bad loans packed with unexplained terms in the first instance. North Carolina research found that abusive lenders flip one in ten Habitat for Humanity borrowers from their interest-free first mortgages into high interest loans.[12] These examples and more motivated the General Assembly to provide for a back-up protection to the law's general high-cost provisions that ensures that no lender may intentionally refinance a homeowner without providing a "reasonable, tangible net benefit" even if the loan falls below high-cost thresholds.

B. The North Carolina law has reduced predatory lending while preserving access to credit.

Contrary to claims by subprime lending associations, recent research clearly shows that the North Carolina law is having its intended effects. Borrowers continue to have access to a wide variety of competitively priced loans from a wide variety of lenders. At the same time, North Carolina has reduced predatory lending.

Industry data attests to the robust subprime market in North Carolina. An analysis by a leading industry trade journal, Inside B&C Lending, found that top North Carolina

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[10] Fannie Mae and Freddie Mac, U.S. Departments of Treasury and Housing and Urban Development, and the Federal Home Loan Bank of Atlanta have all condemned the practice for all home loans. Bank of America, Chase, First Union, Wachovia, Ameriquest, Option One, Citigroup, Household, and American General have all decided not to offer single-premium credit insurance on their subprime loans.

[11] Under various definitions, major subprime lenders (including Household International, Citifinancial, Washington Mutual), the secondary market (including Fannie Mae and Freddie Mac), and many states have subsequently adopted 5 percent or less in points and fees as an appropriate standard.

[12] See "Overview of Habitat for Humanities Refinances" (Coalition for Responsible Lending, Dec. 9, 1999), under Studies at http://www.responsiblelending.org.

subprime lenders continue to offer a full array of products for borrowers in North Carolina—with little or no variation in rate compared to other states.[13] In addition, a Morgan Stanley & Co. survey of 280 subprime branch managers and brokers found that tougher predatory lending laws have not reduced subprime residential lending volumes in any significant way.[14]

Our own analysis of home loans reported to federal regulators as originated under the Home Mortgage Disclosure Act (HMDA) shows that subprime lending continues to thrive in North Carolina.[15] In 2000, North Carolina was still the sixth most active state for subprime lending, with North Carolina borrowers 20 percent more likely to receive a subprime loan than borrowers in the rest of the nation. One in every three loans to low-income North Carolina families (annual incomes of $25,000 or less) was subprime, the highest such proportion in the country. In addition, the study finds that the North Carolina law saved homeowners $100 million in its first year.

The best research in the field was recently completed by the Center for Community Capitalism at the Kenan-Flagler Business School of the University of North Carolina in June 2003.[16] The University of North Carolina study concluded that the North Carolina law succeeded in reducing the incidence of loans with predatory terms, perhaps most notably leading to a 72% drop in subprime prepayment penalties with terms of three years or longer.

On the crucial issue of credit availability, the report found that loans to North Carolina borrowers with substantially impaired credit actually increased by 31 percent after implementation of the North Carolina law. In a corollary finding, researchers noted that subprime loans to borrowers with credit scores above 660—those who could more easily qualify for low-cost conventional loans—declined by 28%, while, according to HMDA data, overall loans by primarily prime lenders increased by 40% in the state from 2000 to 2001. This finding suggests a reduction in "steering" of borrowers to loans with a higher price than that justified by their credit history. In addition, researchers noted that subprime home purchase loans overall increased by 43 percent following passage of the law.

While the number of subprime home purchase loans in North Carolina increased, the number of subprime refinance loans with predatory terms did drop significantly. The UNC study notes that the reduction in originations can be attributed to subprime

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[13] Inside B&C Lending. 2001. Lenders Will Try to Pin Down Effects of NC Mortgage Law. March 5.
[14] Morgan Stanley. 2002. Channel Check: Surprisingly Strong Subprime Growth. Diversified Financials. August 1.
[15] Ernst, Keith, John Farris, and Eric Stein, "North Carolina's Subprime Home Loan Market After Predatory Lending Reform", Center for Responsible Lending (August 2002) (available at http://www.mbaa.org/state_update/2002/nc/nc_study_0814.pdf).
[16] Quercia, R.G., Stegman, M.A., and Davis, W.R. 2003. "The Impact of North Carolina's Anti-Predatory Lending Law: A Descriptive Assessment." Center for Community Capitalism, University of North Carolina at Chapel Hill (available at http://www.kenan-flagler.unc.edu/assets/documents/CC_NC_Anti_Predatory_Law_Impact.pdf). Note: As acknowledged in the study, the Center for Responsible Lending provided financial support to enable the research.

refinance originations that contain at least one predatory lending characteristic: prepayment penalty terms that exceed three years, subprime balloon payments, and loan-to-value ratios of 110 percent or more. UNC considers these loans as proxies for refinance loans that provided little or no benefit to the borrower, but likely resulted in increased fees to the lender, or abusive, unnecessary originations. **In short, the study suggests that the reduction of subprime refinances is consistent with a "weeding out" of bad loans since passage of the law.**

Surprisingly, even though the North Carolina law significantly limited fees, the UNC study also found that, after the law was fully implemented, North Carolina's mean origination interest rates were consistent with corresponding national rates and actually increased slightly less than the national average increase. This result implies that the fees being charged before the implementation of the law were not genuinely priced to borrower risk, but represented excessive fees extracted from North Carolina's most vulnerable populations. In other words, as Professor Michael Stegman, one of the study's authors reported, "[t]he study shows that since the North Carolina law went into full effect, the subprime market has behaved just as the law intended. The number of loans with predatory characteristics has fallen without either restricting access to loans to borrowers with blemished credit or increasing the cost of these loans."[17]

Although an industry-sponsored Credit Research Center (CRC) study claimed that the North Carolina law led to a decrease in access to credit for low-income borrowers, that conclusion should be viewed with suspicion. The CRC study contradicts other industry reports and the weight of available evidence. The CRC study relies upon a limited data set from nine anonymous lenders that has not been made available for independent verification.[18] The CRC study examines data from a period ending June 30, 2000, the day before most of the North Carolina law's provisions took effect. Moreover, the data omits all open-end home loans from those lenders. Finally, the CRC study ignores the problem of "flipping" and consequently assumes that any reduction in subprime originations is evidence of harm. However, any successful anti-predatory lending law would curb the practice of flipping (refinancing loans with no benefit to the borrowers) and thus would tend to reduce the number of subprime refinance originations.

For example, think of the woman from Wilmington, North Carolina, whom I described earlier. Her lender made two refinancing loans in just six months, but—as demonstrated by her eventual foreclosure--the borrower would have been far better off had she not refinanced at all. An effective law, one that prohibited flipping and restricted fees, would have prevented the two loans that led to this woman's foreclosure. This observation shows how an effective law may reduce originations, while still improving

[17] "STUDY: NC Predatory Lending Law Cuts Abuses, Does Not Dry Up Credit for Borrowers", Center for Community Capitalism June 25, 2003 press release (available at http://www.kenan-flagler.unc.edu/News/DetailsNewsPage.cfm?id=466&menu=ki).

[18] The CRC study started with a pool of 1.4 million loans made by nine anonymous members of an industry trade group (that funds CRC) in four states chosen by the authors. The researchers then analyzed one-tenth of these loans. By contrast, the UNC study analyzed 3.3 million loans made by more than twenty lenders in all fifty states. The Loan Performance data set used for the UNC study is the most comprehensive data available on the subprime mortgage market.

the quality of lending in a state. As the UNC study recognized, if the number of loans decreases after the enactment of an anti-predatory loan law, one needs to examine which loans are not being made in order to know whether to worry or celebrate.

Those who claim that North Carolina has a liquidity crisis because of our anti-predatory lending laws are far divorced from the North Carolina mortgage market. Those who live and work in the state know that loans remain widely available. Joseph Smith, North Carolina's Banking Commissioner, has commented that "[d]uring the last twelve months, over seventy-five percent of formal complaints to [his office] ... have involved mortgage lending activities [but] .... [n]ot one of these complaints has involved the inability of a North Carolina citizen to obtain residential mortgage credit."[19]

North Carolina legislators—who have every reason to follow this issue closely—have revisited the law only to strengthen it. A representative of Self-Help recently spoke at a press conference with North Carolina's Governor, Attorney General, and the head of the North Carolina's Bankers Association, celebrating the anti-predatory lending law's success.

C. Other states have built upon North Carolina's successes.

While North Carolina was the first state in the nation to pass strong anti-predatory lending legislation, others have followed and identified appropriate solutions for their particular context.[20] As this Committee examines how the federal government can improve upon the existing federal standards on predatory lending, it is important to recognize that states have served as laboratories of democracy with respect to predatory lending by helping to refine solutions for such issues as assignee liability, the appropriate definition and threshold for points and fees, and the scope of loans included under the law's protections.

Any reforms that attempt to check predatory lending must be mindful of providing meaningful remedies for aggrieved homeowners. Building from existing federal law's provision of assignee liability on high-cost home loans, several states have recognized that balanced assignee liability is essential to protect consumers and responsible lenders.

Assignee liability is essential since most mortgage loans are assigned shortly after origination, so the party collecting and enforcing the note is routinely neither the party that the borrower dealt with nor who originated the loan. Under current commercial law, once a home loan is sold to a third person, homeowners lose virtually all of their rights to defend their homes in court when threatened by the illegal actions of a broker or

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[19] North Carolina Office of the Commissioner of Banks, Joseph A. Smith, Jr. letter to Comptroller John D. Hawke, Jr. (October 2, 2003) (available on request).

[20] Perhaps the most notable states in this regard include New Mexico, New York, and New Jersey—however, Illinois, Massachusetts, California, South Carolina, Arkansas, and Georgia have all made contributions to the pioneering efforts of states to identify solutions that protect homeowners and promote a thriving market.

originator. For years, homeowners found they could live with this arrangement, since the market was closely regulated and loans were largely brokered and originated by a relatively small number of responsible institutions.

Predatory lending, however, changed the equilibrium by introducing unscrupulous brokers and loan originators that lacked the responsible and stable nature of those previously in the market. As a result, homeowners have found themselves without a marketplace they can depend on to deliver loans that are not abusive.

Under current law, homeowners are frequently left unprotected when they seek help from the courts after their home is threatened by loans with illegal terms. Without assignee liability, a family that has been the victim of a predatory loan cannot stop the foreclosure of their home. Instead, they end up losing their home, and then must bring a separate action against the original lender in order to pursue any claims of abusive or illegal practices. This separate action can take years, and the home is long gone before the homeowner even has a chance of recovery against a bad actor. Worse, very often the party that originated the loan is no longer in business and has no assets from which to recover.[21]

Assignee liability corrects a flaw in the home lending market and serves to protect responsible lenders and their customers by encouraging the market to police itself. If there is no assignee liability, an unscrupulous lender can increase the value of the loans it sells by engaging in predatory practices and packing the loan with unnecessary fees, excessive interest rates and large prepayment penalties. Without assignee liability, purchasers of these loans have no incentive to determine if the loans were abusive, and indeed, the loan purchasers reward unscrupulous lenders by paying more for these predatory loans.

In fact, while investors may benefit from some of these abusive terms (i.e. interest rates or prepayment penalty streams), other fees may be extracted by the originator without the investor's knowledge, and may in fact detract from the borrower's eventual ability to maintain payments on the loan. As such, assignee liability serves to ensure that homeowners' rights are more than symbolic. It at once denies capital to support predatory lending and allows homeowners to defend their homes directly.

Even as states have taken action to realize these goals, they have, however, recognized that there are instances when a secondary market purchaser of home loans unintentionally acquires a high-cost home loan despite its intentions and best efforts to refrain from purchasing such risky and abusive loans. In these circumstances, states have

[21] Borrowers seeking a remedy find that brokers typically have substantially fewer assets than lenders (one recent study put the average size of brokerages at ten employees) and are more likely to go out of business and be judgment-proof. *See* Wholesale Access, "New Research About Mortgage Brokers Published," (August 6, 2003) (available at: http://www.wholesaleaccess.com/8.6.03.mb.shtml) and Eggert, Kurt, "Held Up in Due Course: Predatory Lending , Securitization, and the Holder in Due Course Doctrine," Creighton Law Review, v35, n3 (April 2002), 507-640.

recognized that the market has a legitimate interest in the certainty presented by capping damages that may be awarded against an assignee.

Assignee liability is not a new concept or unique to state anti-predatory lending laws. It exists elsewhere in federal and state law, and secondary markets have performed well in those contexts.[22] Since 1976, under the Federal Trade Commission Act, a rule known as the FTC "Holder Rule" has provided for assignee liability for many home improvement and mobile home mortgages that are nevertheless regularly securitized. Many state anti-predatory lending laws have adopted this model with regard to such loans and sought to tighten loopholes regarding the application of the Holder Rule. The key provisions of anti-predatory lending laws build on the example of the federal Home Ownership and Equity Protection Act (HOEPA), which provides for broad assignee liability for high-cost home loans (HOEPA loans), where the investor could tell that the loan was a HOEPA loan, as well as liability under the Truth In Lending Act for rescission claims. Some states also impose assignee liability for usury violations, including on mortgage loans. Car loans also widely carry assignee liability into the securitization market.

The experiences in New Jersey and Georgia show that assignee liability issues can readily be resolved. After rating agencies raised questions about a Georgia law, a resolution was quickly reached that capped the liability of loan purchasers and provided additional protections for loan purchasers who engaged in due diligence. Georgia eventually chose not to enact this provision, and instead adopted a provision that cut off almost all assignee liability. In New Jersey, the Department of Banking and Insurance has taken the lead in addressing concerns with the Garden State's assignee liability provisions. The point is not that either of these states has the perfect solution for predatory lending, but rather that each proved capable of adjusting its standard and, in doing so, may help define which policies protect and which fail to protect homeowners and lenders alike.

Beyond assignee liability, the states that passed laws after North Carolina have developed new definitions of points and fees that expand on the North Carolina definition by including back-end payments to brokers for placing borrowers in loans with higher interest rates than those for which they qualify (yield spread premiums), expanded the scope of loans provided with new protections by ensuring that open-end loans (including home equity lines of credit) are covered, and taken other steps, such as imposing fiduciary duties on mortgage brokers. Each of these steps represent meaningful advances in the evolving debate over how best to solve the predatory lending problem.

[22] In virtually every sale, loan purchasers protect themselves through representations and warranties that require the seller of the loans to indemnify the purchaser for all liabilities arising from the loans. Purchasers also have other tools such as net worth requirements for sellers or ongoing quality control checks to ensure that their investment is protected.

III. FEDERAL PREEMPTION OF STATE ANTI-PREDATORY LENDING LAWS WOULD BE MISGUIDED, AS THE CURRENT FRAMEWORK OF COOPERATIVE FEDERALISM IS WORKING.

Federal preemption of state anti-predatory lending laws would be misguided—and harmful to homeowners. As the framers of our Constitution anticipated, the states and the federal government each have a role to play through "cooperative federalism." As Justice O'Connor has noted,[23]

> The Constitution does not protect the sovereignty of States for the benefit of the States or state governments as abstract political entities, or even for the benefit of the public officials governing the States. To the contrary, the Constitution divides authority between federal and state governments for the protection of individuals. State sovereignty is not just an end in itself: "Rather, federalism secures to citizens the liberties that derive from the diffusion of sovereign power." .... "Just as the separation and independence of the coordinate branches of the Federal Government serves to prevent the accumulation of excessive power in any one branch, a healthy balance of power between the States and the Federal Government will reduce the risk of tyranny and abuse from either front."

Similarly, Justice Rehnquist renews a warning from earlier cases when he writes,[24]

> the scope of the interstate commerce power "must be considered in the light of our dual system of government and may not be extended so as to embrace effects upon interstate commerce so indirect and remote that to embrace them, in view of our complex society, would effectually obliterate the distinction between what is national and what is local and create a completely centralized government."

In practical terms relating to home lending, cooperative federalism means that while the federal government first legislated against predatory home lending through the HOEPA floor, states were free to go further. This dynamic has served the nation well, leading federal regulators to adopt and enable state-developed solutions. Moreover, the states' have moved with caution and have adopted and refined laws with which lenders can comply. Given the benefits and the dearth of evidence to support wholesale changes to the country's respectful approach to cooperative federalism, it is disappointing that one federal agency, the Office of the Comptroller of the Currency (OCC), previously chastised by Congress for being "overly aggressive" in preempting state laws, is once again undermining this process.

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[23] New York v. U.S., 112 S.Ct. 2408, 2431 (1992) (citations omitted).
[24] U.S. v. Morrison, 120 S. Ct. 1740, 1749 (2000) (citations omitted).

A. Federal agencies have learned from state-based efforts to address predatory lending.

In at least two cases, federal agencies have learned from and acted upon lessons developed at the state level. In adopting changes to their regulatory framework, the Federal Reserve Board and the Office of Thrift Supervision each exemplified the best ideals of federalism.

The Federal Reserve Board took important action in 2001 when it moved to incorporate financed credit insurance within the scope of charges evaluated as a point of fee under HOEPA. But, the Federal Reserve did not arrive at this conclusion in a vacuum. Indeed, the first jurisdiction to reach such a conclusion was the state of North Carolina, which adopted a similar provision in its 1999 law. Even as North Carolina reached the conclusion that such products were harming consumers, it recognized that legitimate forms of credit insurance, calculated and paid on a monthly basis, did not have harmful equity stripping effects and should not be subject to the same scrutiny. Following the law's effective date, many lenders publicly disclaimed such products and the market appears to have successfully transitioned to the monthly product. Consequently, the Federal Reserve acted responsibly when it saw that similar benefits could be extended through the federal HOEPA floor to borrowers in all states.

Similarly, some 35 states currently have statutory provisions relating to prepayment penalties on home loans. Yet, federal law had been interpreted to preclude them from enforcing those laws against state-chartered finance companies and mortgage brokers in adjustable rate mortgages (ARMs) and other alternative mortgage transactions. Increasingly, prepayment penalties in home loans have come under scrutiny and a number of states have moved to prohibit them outright or to limit their application. In recognition of these developments, the Office of Thrift Supervision took commendable action when it revised federal regulations in a way that promoted cooperative federalism by restoring the states' rights to apply their laws to these state-chartered institutions.

B. States are best equipped to respond to abuses in their particular markets.

We urge you today to continue in this vein and partner with states to provide protections for the nation's homeowners. In addition to losing the opportunity for synergy with state efforts, federal preemption of state law is not a practical response to predatory lending because states are in the best position to respond to many of the challenges presented by predatory lending, for at least three reasons: (1) many of the bad actors involved in predatory lending are state-chartered entities with minimal capitalization, (2) regional variations in real estate markets require different solutions to predatory lending, and (3) irresponsible lenders can invent new abusive practices virtually overnight, and the federal government is ill-equipped to react quickly to these changes.

First, federal enforcement of financial services laws depends largely on periodic examinations of the practices of large institutions. The broker who just hung a shingle from his door, however, can originate abusive loans without much fear of federal oversight—as can a state-chartered affiliate of a bank that is not likely to affect its larger parent's overall safety and soundness. State attorneys general and bank regulators have been instrumental in investigating abusive practices and in demanding redress for their citizens. They are also the primary regulators of non-depository finance companies, which dominate the subprime market. The federal government simply cannot be everywhere at once to monitor local real estate transactions.

Second, predatory lending laws should address the special characteristics of each state's underlying real estate regime and market. For example, the mechanism for ensuring that a borrower can raise defenses to foreclosure on predatory home loans may depend on whether a state has judicial or non-judicial foreclosure procedures. The appropriate loan-size threshold for when to prohibit prepayment penalties may depend on the real estate values in a given state. North Carolina prohibits prepayment penalties in fist-lien home loans of less than $150,000. In Maryland or Virginia, the most reasonable threshold would perhaps be considerably higher.

Third, new financial services products are developed every day, frequently to exploit loopholes in laws against abuse. In North Carolina, the legislature prohibited the sale of financed credit insurance. Within two years, the similar "but-not-insurance" product of "debt cancellation agreements" was born. State legislatures are better suited than Congress for responding quickly to such changes.

C. Lenders have experience complying with a variety of state laws that affect their business practices, and complying with state-based homeowner protection laws (which prohibit activities that they should not be engaged in anyway) presents no heavier a burden.

Given the evidence of success at the state level, Congress would do harm to homeowners by imposing a uniform standard in lieu of state protections. Every day, lenders deal with tremendous variety in state real estate laws and practices, including consumer protection laws.[25] The laws concerning who may act as a settlement agent differ from state to state. Foreclosure law differs from state to state. States have their own fraud and deceptive practices acts, interpreted by state court judges in accordance with state-specific common law. Just as lenders find tools for complying with these and other variations, we believe that they are capable of complying with state-based homeowner protection statutes as well. The market has responded by producing computer products that claim to assist lenders in their compliance obligations across state borders.[26] In fact, the variation in these statutes is actually quite small, and we can expect

[25] Significantly, federal laws such as the Fair Housing Act and the Equal Credit Opportunity Act regulate the real estate finance market without broadly preempting comparable state regulations.
[26] *See* Bergquist, Eric, "Some Lenders Turning to Compliance Software", American Banker, v168, n62 (April 1, 2003).

states to move even closer to a consensus approach as regulation of predatory lending improves in its ability to curb abuses.

IV. CONCLUSION

For all the reasons just stated, Self-Help and the Coalition strongly oppose federal preemption of states' anti-predatory loan laws whether through regulatory[27] or legislative means. In doing so, we stand beside every single state's Attorney General and the Conference of State Bank Supervisors which have similarly objected to federal preemption of state anti-predatory lending laws.[28] Indeed, our federalist system of government provides for both state and federal government to play a role in protecting borrowers. The dual banking system provides for positive competition that is the envy of the world. Operating as laboratories of democracy, the states have developed increasingly effective approaches to eradicating predatory lending without drying up access to reasonably priced subprime mortgage credit. This is federalism at its best.

At the end of the day, however, whether legislator, lender, or advocate, it is incumbent on all of us to stay focused on the important goal that we all share: namely, the provision of a safe mortgage market that American families can trust with effective protections and remedies for those homeowners who fall prey to unscrupulous lenders. Thank you for the opportunity to speak to you today, I am happy to answer any questions you may have for me.

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[27] Recently, we submitted a detailed letter explaining our primary objections to the Office of the Comptroller of the Currency's proposed rulemaking on preemption, an agency that has previously been taken to task by Congress for being "overly aggressive" in this regard (*See* legislative history to the Interstate Bank Branching and Efficiency Act of 1994). The OCC proposal is misguided for two reasons especially relevant to the instant discussion.

First, the analysis underlying the proposed rulemaking is obviously outcome-driven. The OCC's factual foundation for deciding that state laws interfere with the operation of national banks is based in significant part on an uncritical reading of the CRC study. The OCC also focuses its analysis on subprime mortgage interest rates, ignoring evidence of abuse though excessive fees and the states' focus on this problem. The weight of available research certainly does not support the OCC's conclusion that state anti-predatory lending laws are harmful.

Second, the OCC's proposed rulemaking fails to include meaningful protections for borrowers. Rather, the OCC proposal would substitute a single provision (against loans made without regard to a borrower's ability to pay) for the comprehensive state laws it would preempt.

[28] National Association of Attorneys General letter to the Office of the Comptroller of the Currency (October 6, 2003) (available on request); and Conference of State Bank Supervisors letter to Comptroller Jonathan D. Hawke, Jr. (September 26, 2003) (available at http://www.csbs.org/government/regulatory/comment_ltrs/cl_09.29.03.pdf).

George W. Brown

Mr. Brown's distinguished 30-year career includes accomplishments in the private sector, public sector and the community. He was hired recently (June 2003) by Self-Help and the Center for Responsible Lending. Based in Durham, North Carolina, Self-Help is the nation's largest nonprofit community development lender, creating and protecting ownership opportunities for low-wealth families through home and small business ownership. Self-Help has provided over $2.5 billion in financing to help more than 30,000 low-wealth borrowers buy homes, build businesses, and strengthen their communities.

The Center for Responsible Lending is focused on policy research and advocacy to stop predatory lending practices. An affiliate of Self-Help, the Center was instrumental in helping to pass the country's first comprehensive state statute against predatory mortgage lending. Self-Help has been a leader on national legislative and regulatory efforts to address predatory lending.

Most recently before joining Self-help, Mr. Brown was a founder and President of a faith-based community development corporation in Washington, DC. The Far SW-SE Community Development Corporation (CDC) was formed in 1998 and is the first "green" CDC in the District – focusing on sustainable and environmentally sensitive economic development. This CDC operates in the most racially polarized and economically depressed community in the District. During his tenure, Mr. Brown was responsible for raising almost $2 million dollars of equity for the development and revitalization of the only commercial strip in the community served by the CDC. The CDC has just opened a state of the art community technology center serving over 200 youth.

Prior to the CDC, Mr. Brown was the Vice President of Marketing and Chief Compliance Officer, for The Edgar Lomax Company, a Virginia-based investment management firm. From 1991 to 1994, he served the District of Columbia government, first as the Deputy Director for Business and Economic Development and then, beginning in 1992, as Deputy Mayor for Economic Development.

Mr. Brown served as the Associate Deputy Assistant Secretary for Neighborhoods with the U.S. Department of Housing and Urban Development, as managing partner in the law firm of Ellis, King, Brown & Prioleau, Program Officer for the Ford Foundation, and Program Director for the Local Initiatives Support Corporation (LISC). Mr. Brown was one of the first program officers for this nationally acclaimed community development financing intermediary. While at LISC, he established local programs in California and Washington, DC.

In 1976, Mr. Brown was nominated by the Secretary of HUD and selected by President Jimmy Carter as a Presidential Executive, working with Bank of America in developing its community reinvestment program. Mr. Brown has been involved in the development of over 300 affordable single-family and multifamily housing developments and five office complexes. He as lectured on Special Housing Needs at Yale and Columbia University, and was a delegate to a UN-sponsored conference on special housing needs in The Hague.

Mr. Brown resides in and is a native of Washington, DC, growing up in the very neighborhood he served with the Far SW-SE CDC. He is a graduate of Howard University and Georgetown University Law Center, both located in Washington, DC. He has received many honors, which include the highest meritorious service awards from the Department of Housing and Urban Development and the District of Columbia. His community activities are numerous, truly reflecting the spirit of service above self. He is an active leader in his church, the Living Word Church.

Statement of Robert M. Couch

President & CEO
New South Federal Savings Bank
Birmingham, AL

on behalf of

Mortgage Bankers Association

before the

Financial Services Housing and Financial Institutions Subcommittees

U.S. House of Representatives

Hearing on

"Preventing Abusive Lending While Preserving Access to Credit."

November 5, 2003

Good morning Mr. Chairman and members of the Committee. My name is Rob Couch, and I am President and CEO of New South Federal Savings Bank, in Birmingham, Alabama. Today, I appear before you as Chairman of the Mortgage Bankers Association (MBA).[1]

I commend the Committee's leadership in calling for hearings on the vital matter of consumer abuse in mortgage lending, and want to thank you for inviting MBA to participate in the very important undertaking of exploring the methods by which we can stem so-called "predatory lending." As Chairman of the trade association that represents the real estate finance industry, and as President of an institution that is primarily engaged in mortgage lending, I am personally very disturbed by any reports of consumer abuse in our industry.

At the outset, I want to declare that MBA condemns abusive and so-called "predatory lending" practices in the strongest possible terms. We want this committee to know that this association has been an active and dependable partner in the continuous search for solutions to this problem. Although it is quite difficult to accurately measure and quantify abusive mortgage lending activity, MBA does not shy away from the fact that certain rogue lenders and unscrupulous brokers have preyed upon our most vulnerable citizens. MBA accepts the need to act in the face of these continuing abuses.

We warn, however, that as we search for solutions and better protections for American homeowners, we also have the duty and obligation of ensuring that we do not act in a way that constricts the flow of capital to credit-starved communities. Our industry has

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[1] MBA is the premier trade association representing the real estate finance industry. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets, to expand homeownership prospects through increased affordability, and to extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters excellence and technical know-how among real estate professionals through a wide range of educational programs and technical publications. Its membership of approximately 2,700 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, life insurance companies and others in the mortgage lending field.

been extremely successful in expanding access to mortgage capital to all segments of our population, and we cannot afford to reverse on these hard-earned advances.

I. Overview of MBA Position on Predatory Lending

Let's set the record straight—"predatory" mortgage lending is not a new problem; in fact, it is only the current manifestation of what we have traditionally referred to as "mortgage fraud." In the end, the tactics used by unscrupulous actors in "predatory lending" schemes are aimed at deceiving consumers, hiding the true costs of the transaction, and blinding unsuspecting and unsophisticated homeowners from the full marketplace of competitive products and services.

MBA believes that "predatory lending" has three fundamental root sources that need to be jointly attacked. These are (1) the complexity of the laws and mandated disclosures, (2) the lack of consumer education, and (3) the lack of adequate enforcement of existing laws. Any attempt to achieve long-lasting solutions in this area must, necessarily, isolate these specific causes and address them through carefully tailored approaches.

Complexity of Mortgage Laws

First and foremost, we believe that a root problem leading to abusive lending is the confusion created by the complexity of the laws and disclosures that apply to the mortgage process. Mortgage-related disclosures are voluminous and often cryptic. Consumers rarely use these forms and disclosures to compare prices or identify the terms of the transaction because, quite simply, they cannot understand what they read nor what they sign. In addition, the mandated forms lack reliable cost figures, a fact that impedes prospective borrowers from ascertaining true total costs.[2]

[2] There are various confirmations of this core problem. In a 1998 report prepared by the Federal Reserve Board and the U.S. Department of Housing and Urban Development, these federal agencies ascertained that most consumers do not understand the relation between the contract interest rate and the Annual Percentage Rate ("APR") listed in the Truth in Lending disclosures. The agencies explain that "the [consumers'] belief was based on misconceptions about what the disclosures represent. For example, consumers believed the APR represents the interest rate... and the amount financed represents the note amount... ." These are fundamental misunderstandings that can lead to very serious repercussions for unwary or unsophisticated shoppers. In fact, there are reports that these cryptic forms, and the public's misunderstanding of them, make the federally-required Truth in Lending disclosures a very useful tool for predators to confuse and defraud consumers.

More urgently, however, we note that the complexity of the current system serves as the camouflage that allows unscrupulous operators to hide altered terms and conceal crucial information without fear of the consumer discovering or even understanding the import of the masked or undisclosed items. In light of this complexity, confounded borrowers stop shopping and turn to loan officers for advice. In instances of abusive originators, the consumer's total reliance on a third party closes the loop of deception—the victims of these scams are completely blinded to the realities and repercussions of the transaction. These problems are exacerbated in instances of uneducated, illiterate, or non-English-speaking consumers.

Lack of Consumer Awareness/Education

The complexity of the mortgage process leads directly to, and is intertwined with, the second source of predatory lending—lack of consumer awareness and education. It is a reality today that even well-educated consumers tend to lack basic understanding of the mortgage shopping and home buying processes. We know, for example, that most consumers understand neither the meaning nor importance of the "Annual Percentage Rate" figure. Nor do mortgage shoppers entirely comprehend that the early Good Faith Estimate disclosures are not "guaranteed" or final. These misunderstandings have very real repercussions regarding the choices that consumers make and the products that they ultimately select. Misperceptions regarding these disclosures, or failure to understand their content, create an environment that is ripe for the manipulation and exploitation of consumers by devious and unscrupulous operators.

Lack of Enforcement

A third problem creating a favorable environment for abusive lending is the general absence of real enforcement of the multitude of loans that apply to this area. It is important to understand that mortgage lending is one of the most heavily regulated industries today. Mortgage lending is subject to pervasive state regulation and lenders must comply with a wide array of federal consumer protection laws including the Truth in Lending Act, Real Estate Settlement Procedures Act, Fair Housing Act, Fair Credit

Reporting Act, Equal Credit Opportunity Act, Fair Credit Billing Act, Home Mortgage Disclosure Act, Federal Trade Commission Act, and Fair Debt Collection Practices Act. Many of the "predatory" abuses reported today either violate current law or result from lack of disclosures that violate current laws. As noted earlier, in practically all instances of abuse, the "predatory" lender uses these and other disclosures in a way that involves outright fraud and deception.

In addition, states generally have laws that can be used to effectively combat abusive mortgage lending practices. These include: prohibitions against unfair and deceptive trade practices; prohibitions against discrimination and redlining in finance transactions; limitations on specific terms of consumer and mortgage credit; limitations on insurance products; penalty provisions for non-compliance; prohibitions of deception misrepresentation; non-disclosure and concealment; and common law rules against fraud.

In summary, MBA believes that any approach that does not address these three basic prongs—simplification, education, and enforcement—will merely deal with the effects and not with the underlying causes of the problem.

II. Importance of National Mortgage Markets

Before identifying methods to address the root causes of "predatory lending," it is extremely important to understand the structure of today's vibrant mortgage market. It is crucial to recognize that the vast majority of mortgage loans are no longer made from bank reserves or monies derived from depository sources; rather, mortgage loan capital is largely obtained from securitization and the sale of mortgage-backed assets to secondary market investors.[3] In the modern mortgage market, most of the capital used by lenders to fund mortgages is derived from national and international capital sources that include Fannie Mae, Freddie Mac, Ginnie Mae, Federal Home Loan Banks, and a

[3] Our estimates reveal that, in 2002, over 75% of all U.S. residential mortgage production was securitized and sold into the secondary market.

wide array of private investor sources. Mortgage lending is therefore conducted on a truly national scope. These national sources for mortgage capital have served to achieve great cost savings for consumers through added efficiencies and considerable economies of scale. These secondary market entities have produced a uniform national mortgage market by enabling transfers of capital and excess savings from money-rich areas to money-poor areas.

This truly amazing mortgage structure, based upon an international secondary market, has given the American population the best, cheapest, and most efficient mortgage capital delivery system in the world. This highly functional secondary mortgage market is, however, greatly dependent on legal certainty and predictability. In short, secondary market investors must have the security of being able to purchase and trade mortgage-backed assets without undue complications and without excessive legal risk. In this sense, only standardized lending rules will provide capital markets with the foundation of necessary legal uniformity that ensures enforceability of particular transactions while facilitating securitization and the flow of capital.

III. "Subprime" Lending

This mortgage system has been especially important with regard to the so-called "subprime" market sector. This sector of the market focuses on portions of the population composed of consumers that, for various reasons, have less than stellar credit records or other flaws. These consumers can very often still be considered viable credit candidates, often with the assistance of financing options that serve to mitigate credit risks. It is important to realize that until a few years ago, this segment of the population did not have the option of obtaining mortgage financing from traditional lending institutions, as creditors would only risk lending large sums of money for long terms to those individuals that possessed faultless credit scores. However, through innovations in the mortgage finance industry, and through various financing and risk enhancing tools created for the specific purpose of extending credit to our more needy communities, credit-impaired individuals now have ample opportunity to obtain loans through this "non-prime," or "subprime" market.

This segment of the industry has become an increasingly important, and very essential, piece of mortgage lending. As the U.S. Department of Treasury and the Department of Housing and Urban Development acknowledge in a recent report, "[b]y providing loans to borrowers who do not meet the credit standards for borrowers in the prime market, subprime lending provides an important service, enabling such borrowers to buy new homes, improve their homes, or access the equity in their homes for other purposes."[4] Although subprime originations comprise approximately 9% of all mortgage originations, over the past few years, we have seen tremendous growth in subprime lending. According to Federal Reserve Board estimates, subprime mortgage originations grew seven-fold over the 1994-2002 period. This growth has disproportionately benefited low-income and minority borrowers, as these groups are much more likely to rely on subprime credit. One clear and visible outcome of this expanded subprime lending activity has been an increase in homeownership rates for low-income and minority borrowers. According to Federal Reserve Governor Gramlich, "this represents a welcome extension of home mortgage and other credit to previously underserved groups—a true democratization of credit markets."[5] MBA agrees. We note that millions of low- and moderate-income families now have a chance at owning a home and building wealth due specifically to the rapid growth of subprime credit.

IV. Proliferation of State and Local Predatory Lending Laws

The products that are allowing for this incredible and unprecedented expansion of credit access to needy communities are, however, coming under increasing threat. As has been widely reported, there is currently an unprecedented level of legislative activity aimed at passing so-called "anti-predatory" measures at state and local levels.

[4] United States Department of Treasury and Department of Housing and Urban Development, *Curbing Predatory Home Mortgage Lending: A Joint Report*, June 2000 ("HUD/Treasury Report").
[5] Remarks by Governor Edward M. Gramlich at the Texas Association of Bank Counsel, 27th Annual Convention, South Padre Island, Texas (October 9, 2003).

Although well-intentioned, these state and local laws are posing restrictions that hamper lending operations in the subprime market while creating a "balkanized" legal system that threatens secondary market operations and damages our industry's ability to deliver mortgage capital to underserved communities.

Effects

The harmful effects of state-level legislation are multi-faceted. As a threshold item, we observe that none of these state-based laws sets forth a uniform or workable definition for "predatory lending," or what constitutes "abuse" in the context of mortgage lending. Indeed, the terms "predatory lending" and "subprime lending" are often and repeatedly used interchangeably. In public debates, official reports, and media coverage surrounding this highly politicized issue, it is often openly asserted, for example, that higher-than-normal interest rates or the presence of certain terms, such a balloon provisions, are inherently predatory. Sometimes, a minor regulatory deviation will be referred to as a "predatory scheme." These fallacies continue to poison the discourse on this very important subject and make clear that there is no consensus on a premise from which to advance.

A further element of "predatory lending" legislation at state and local levels is that it focuses on enacting increasingly burdensome restrictions and outright prohibitions on specific loan terms, such as prepayment fees and late charges. These loan terms have legitimate uses; they enhance a lender's ability to structure credit for consumers with special needs and exceptional circumstances—credit impairments, irregular income streams, etc.—and to allow them to be able to access the equity in their homes. By imposing restrictions and prohibitions against useful financing tools that are misused by a few unethical actors, state laws are damaging the entire home equity market.[6]

[6] See, e.g., New York's prohibition of "balloon notes" in covered loans (*General Regulations of the Banking Board, Part 41 ("Restrictions and Limitations on High Cost Home Loans")*); New Jersey's complex restrictions on "prepayment penalties" in covered loans (*New Jersey Home Ownership Security Act of 2002* (Assembly Bill No. 75)).

Diminution of Credit

MBA believes that all these negative effects give rise to truly disastrous outcomes. In their zeal to protect vulnerable consumers, state legislators and consumer groups are creating a hostile legal regime that is causing lender flight and diminishing capital access for the most needy segments of our communities. The subprime market, by definition, depends on the ability of creditors to effectively control for the borrowers' credit risks; by eliminating risk-abating financing tools, state legislators and consumer groups are crippling lenders' ability to ensure the proper delivery of subprime capital.

Moreover, these very confusing state and local laws that purport to protect consumers are imposing a veritable maze of "triggers," disclosures, and prohibitions on covered mortgage loan products. The proliferation of these laws creates massively complex compliance labyrinths that are entirely unwieldy. Multi-state lenders today find it extremely difficult, if not impossible, to formulate models for compliance in any one geographic location without the high probability of falling out of compliance in a different locality. In fact, the unending passage of these "predatory lending" laws at state and local levels is creating a situation where multi-state lenders are finding it almost impossible to comply, or even keep up with, with the full barrage of local rules and regulations that are continually enacted.

Equally critical is the very negative impact of these state legislative developments in terms of the secondary market. We note that secondary market investors follow strict compliance and quality assurance requirements to ensure that the assets they purchase are comprised of loans that meet the requirements of state and federal law. The fragmentation of legal requirements caused by differing state legislation imposes crippling confusion for purposes of purchasing and enforcing mortgage loans since every individual portfolio in a given national pool of loans could carry differing legal requirements based on the particular state where the loan was originated. In such an environment, secondary market operations are in disarray, as complex questions of compliance and enforceability drown efficient flows of mortgage capital. In the current "balkanized" environment, secondary market players are now required to undertake extensive, and extremely costly, due diligence analyses, reach detailed conclusions relating to specific loan originations as part of expanded due diligence processes, and implement costly operating systems to comply with varying and ever-changing laws.

If that were not enough, these difficulties are now being exacerbated by recent enactments of state legislation that impose unlimited purchaser or assignee liability for the practices of an originator, broker, or even servicer. This trend has begun to draw a strong negative reaction by all segments of the secondary market community. In the past several months, rating agencies such as Fitch and Standard & Poors have refused to rate assets that contain loans originated in jurisdictions that impose liability on assignees. This trend is dangerous, as the agencies' refusal to rate assets is extremely alarming to investors, and will invariably dry up secondary market investment. It is likely that the agencies' refusal to rate covered assets will severely restrict funding for all loans covered by these laws.

In the end, we note that the clear impact of this burdensome, confused, and fragmented regulatory framework at the state and local level is lender and investor flight from the states and municipalities covered by these laws. The experience in the State of Georgia is very illustrative. In 2002, that state enacted the Georgia Fair Lending Act ("GFLA") to stop unscrupulous lending activity in mortgage lending. That law was so broad in its application, and contained so many undefined terms, ambiguities and misclassifications, that even traditional lenders exited the market. The secondary market reacted very negatively, in chorus with decisions by the rating agencies to refrain from rating any securities containing loans covered by the GFLA. In due course, Georgia's state legislators returned to amend the law in order to halt the flight of mortgage capital from the state. This legislative experiment, though well-intentioned, cost the industry millions of dollars in compliance and legal fees, and proves that this type of state legislative activity has direct and dramatic effects on lenders' willingness to do business in particular markets.[7]

It should be noted that lender and investor flight will not only decrease capital availability in affected markets, but will, with all certainty, raise the costs of the remaining sources of mortgage capital. If legitimate institutional players leave this market segment, the price of capital in those markets will skyrocket as supply is diminished relative to demand. If history is a lesson, supplies of capital could decrease to the point of pushing cash-strapped consumers to non-traditional, and indeed very costly and even dubious, money sources.

In summary, the growing number of state and local "predatory lending" laws hurt precisely those populations that they are meant to benefit.

V. Steps to Address Abusive Lending

As we search for solutions, we believe that mortgage industry participants, policymakers, and consumer representatives all share a sincere desire to end the abuses. This must, however, be done in a way that does not reverse the tremendous strides that have been made to expand mortgage capital to all communities. Let me then address the steps MBA believes should be taken in order to bring a lasting solution to this problem.

Education of Consumers

First, as outlined above, educating consumers is most basic step in the struggle to push predators out of our neighborhoods. MBA continues to believe that the most effective weapon against abusive lending is a well educated consumer in a competitive marketplace.

[7] For an excellent description of the unintended harms of the GFLA, see "*Georgia Fair Lending Act: Unintended Consequences*," Georgia Credit Union Affiliates, Community Bankers Association of Georgia, Georgia Bankers Association (January2003).

To this end, MBA has created a consumer education program called "*Stop Mortgage Fraud*." This consumer financial literacy program—available in English, Spanish, and, soon, in Arabic—is written in plain language, and attempts to provide useful guidance to consumers about how they can protect themselves in potentially abusive situations. The information provided by MBA's program gives consumers three important tools they can use to help prevent them from being subject to "predatory lending" practices:

a. Borrower's Bill of Rights – which provides a detailed listing of consumer rights during the mortgage transaction from the first contact with a lender/broker to the closing of the loan.
b. 10 Warning Signs of Predatory Lending – which lists the 10 common warning signs of predatory lending. These signs include everything from being asked to leave signature lines blank to being encouraged to include false information on a loan application.
c. Where to Report Suspected Predatory Lending – consumers can either visit the www.stopmortgagefraud.com Website or call a specified toll-free number (1-800-348-3931) to get information on what steps to take to file a complaint. Consumers calling the 800 number will receive a brochure that contains information also found on the Website.

Enforcement of Existing Laws

MBA strongly believes that much more must be done to enforce the laws that are currently on the books. In the past quarter century, both federal and state governments have put in place a far-reaching body of laws designed to prevent abuse of consumers in credit transactions. As mentioned above, there are myriad laws that exist at the federal and state levels that could effectively address the abuses that are occurring in the market today.

MBA has been extremely proactive in the process of exploring the necessary steps to ensure that state and federal authorities are properly equipped to adequately enforce existing laws. In June 2003, MBA hosted an Enforcement Summit in Washington, DC, that was attended by federal policymakers, consumer groups, key federal and state regulators, and real estate finance industry representatives. At the Summit, MBA discussed federal as well as state and local enforcement of consumer protection laws and reviewed a number of alternative approaches to combat abusive lending practices.

Summit participants identified the following as appropriate action steps toward further consumer protection:

- Increase resources for enforcement by exploring ways to generate new funds through a financial assessment program with generated funds being targeted at increasing effectiveness of enforcement, promoting anti-abusive lending practices and increasing the visibility of federal state and local regulators.
- Study and develop recommendations on establishing a National Resource Center and Clearinghouse for financial education, literacy and counseling.
- Explore innovative ways to reach consumers who may be vulnerable to potential abusive lending practices, including establishing a Financial Literacy Month.
- Commission a study on the practices of abusive lenders.

In the coming weeks, MBA will release a report summarizing the key discussions and findings of the Summit. For MBA, this Summit represents the beginning of meaningful communications with all groups interested in resolving problems and issues surrounding abusive mortgage lending.

In addition, MBA understands that enforcement efforts are not easy undertakings. They require time, careful examinations, documentation of disclosures, documentation of sales techniques, and interviews with parties involved, among other things. This approach, however, is one of the most effective ways to stamp out abusive lending practices. To this end, MBA calls for increased funding of consumer protection agencies to provide them all necessary resources so that we may more effectively clamp down on unscrupulous actors.

Mortgage Simplification

MBA has consistently argued that no regulatory approach will deliver true consumer protection unless underlying market defects are addressed through a comprehensive reform of the mortgage lending laws. The real key to achieving true long-term reform in the subprime market does not lie in limited efforts to drive out bad practices and bad actors from the market. Rather, the critical reform objective should be to attract reputable lenders into a marketplace of consumers that are able to make educated decisions with a wide variety of terms and options. A competitive market with informed consumers provides the best protection against predatory activity.

As mentioned above, predatory lending is in many ways a symptom of larger problems that have evolved from complicated and outdated mortgage laws. Without broad changes to existing laws and comprehensive reform of current cost disclosures, any efforts to address predatory lending will merely deal with the effects and not with the underlying causes of the problem. If the process remains confusing and perplexing, consumers will continue to be tricked and deceived.

Uniform Standard

A most important point that MBA wants to bring to the forefront, stemming from all the difficulties identified above, is that the only way to ensure the proper and efficient delivery of mortgage capital to our neediest populations is to develop a national solution to "predatory" lending. We therefore urge this Committee to support us in the push for an efficient marketplace through the establishment of a uniform national standard to combat abusive lending practices.

MBA believes that a single standard will encourage competition, and will ensure that the entire mortgage lending industry complies with one set of laws while allowing consumers to have a greater grasp of the lending process to keep them from falling prey to unscrupulous practices. We believe that we can, and must, craft strong safeguards that afford effective levels of protection for all of our citizens and that preserve the efficiencies of a unified legal structure.

As I noted before, such a uniform national standard for mortgage loans is the only realistic solution in an industry that operates and accesses capital from national, and indeed international, sources. MBA is not alone in this request. I note that every major player in the mortgage industry is appealing to bring order to the bewildering fragmentation of the mortgage market. In the past several months, the Office of Thrift Supervision ("OTS") has acted to issue preemption orders with regard to local "predatory lending" laws in New York, New Jersey, Georgia, and New Mexico that restrict the activities of thrift institutions. We understand that the OTS is reviewing other state legislation as well. As we speak, the Office of the Comptroller of the Currency ("OCC") is considering issuing regulations that would set forth a national preemption standard for national banks generally.[8] Another important pronouncement has come from the Government-Sponsored Enterprises. Only a few weeks ago, in unison, both Fannie Mae and Freddie Mac declared their support for the creation of a national preemptive standard that resolves the mounting difficulties imposed by the current patchwork of local laws.

We ask this committee to listen to the urgent and combined calls for the development of national uniform standards to fight against "predatory lending." Our most credit starved communities will be the principal losers if we fail to act.

VI. Conclusion

In summary, MBA believes that the search for solutions to the vexing problem of abusive mortgage lending must include comprehensive attention to all the underlying factors that allow predatory lending to flourish. We must address predatory lending through direct attacks on three fronts: a commitment to full enforcement, robust education, and a simplification of existing laws. As we do this, we must also come to agreement about the need for an efficient marketplace through the establishment of

[8] See 68 Federal Register 46119 (August 5, 2003).

uniform national standards that assemble and focus our efforts in the fight against abusive lending practices.

Thank you for the opportunity to appear before the Committee. I look forward to answering all your questions.

American SECURITIZATION FORUM

Statement of Cameron L. Cowan
Partner
Orrick, Herrington, and Sutcliffe, LLP
On behalf of the American Securitization Forum

Before the
Subcommittee on Housing and Community Opportunity
Subcommittee on Financial Institutions and Consumer Credit
United States House of Representatives

Hearing on Protecting Homeowners: Preventing Abusive Lending While Preserving Access to Credit
November 5, 2003

Thank you Chairman Ney and Chairman Bachus for holding this hearing and the opportunity to testify today on the role and importance of securitization in the mortgage industry. My name is Cameron Cowan. I am a partner at the law firm of Orrick, Herrington, and Sutcliffe. Within Orrick, I serve as the Managing Director of Finance Practices and as a member of the firm's Executive Committee. I am also a member of the American Securitization Forum's (ASF) Executive Committee and I chair the ASF's Legislative and Judicial Subcommittee. The ASF, an affiliate of The Bond Market Association, is a broadly-based professional forum of participants in the U.S. securitization market. Among other roles, the ASF members act as investors, issuers, underwriters, dealers, rating agencies, insurers, trustees, servicers and professional advisors working on transactions involving securitizations.

For the last 16 years, my law practice has focused on structured finance—also known as securitization. My knowledge of subprime and predatory lending generally comes from the perspective of the secondary market. In my testimony today, I will focus on the securitization process, the growth of the industry and the many benefits securitization brings to consumers (including subprime borrowers), investors and issuers.

History and Overview of Securitization

Securitization is the creation and issuance of debt securities, or bonds, whose payments of principal and interest derive from cash flows generated by separate pools of assets. It has grown from a non-existent industry in 1970 to $6.6 trillion as of the second quarter of 2003. Financial institutions and businesses of all kinds use securitization to immediately realize the value of a cash-producing asset. These are typically financial assets such as loans, but can also be trade receivables or leases. In most cases, the originator of the asset anticipates a regular stream of payments. By pooling the assets together, the payment streams can be used to support interest and principal payments on debt securities. When assets are securitized, the originator receives the payment stream as a lump sum rather than spread out over time. Securitized mortgages are known as mortgage-backed securities (MBS), while securitized assets—non-mortgage loans or assets with expected payment streams—are known as asset-backed securities (ABS).

To initiate a securitization, a company must first create what is called a special purpose vehicle (SPV) in the parlance of securitization. The SPV is legally separate from the company, or the holder of the assets. Typically a company sells its assets to the SPV. The payment streams generated by the assets can then be repackaged to back an issue of bonds. Or, the SPV can transfer the assets to a trust, which becomes the nominal issuer. In both cases, the bonds are exchanged with an underwriter for cash. The underwriter then sells the securities to investors. Unlike other bonds, securities backed by mortgages usually pay both interest and a portion of the investor's principal on a monthly basis.

Mortgage-Backed Securities

The first mortgage-backed securities arose from the secondary mortgage market in 1970. Investors had traded whole loans, or unsecuritized mortgages, for some time before the Government National Mortgage Association (GNMA), also called Ginnie Mae, guaranteed the first mortgage pass-through securities that pass the principal and interest payments on mortgages through to investors. (Ginnie Mae is a government agency that guarantees securities backed by HUD- and Veterans Administration-guaranteed mortgages.) Ginnie Mae was soon followed by Fannie Mae, a private corporation chartered by the federal government—along with Freddie Mac—to promote homeownership by fostering a secondary market in home mortgages.

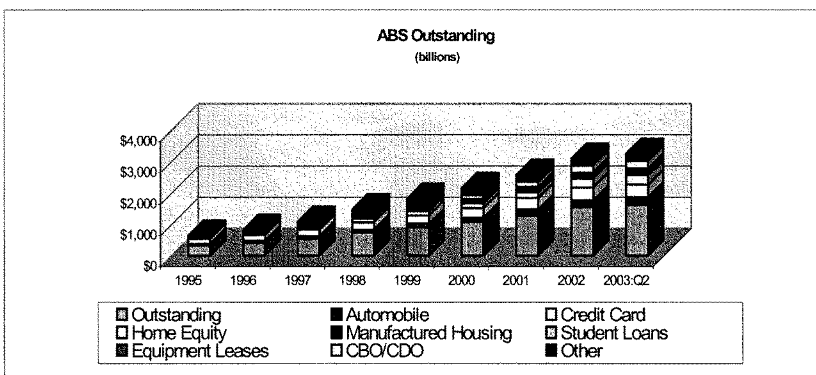
Pass-throughs were a dramatic innovation in the secondary mortgage market. The whole-loan market, the buying and selling of mortgages, was relatively illiquid. This presented a risk to mortgage lenders who could find themselves unable to find buyers if they wanted to sell their loan portfolios both quickly and at an acceptable price. Holding the loans also meant exposure to the risk that rising interest rates could drive a lender's interest cost higher than its interest income. But trading whole loans meant a raft of details and paperwork that made the business relatively costly. MBS changed that. By combining similar loans into pools, the government agencies are able to pass the mortgage payments through to the certificate holders or investors. This change made the secondary mortgage market more attractive to investors and lenders alike. Investors now had a liquid instrument and lenders had the option to move any interest rate risk associated with mortgages off of their balance sheet.

Growth in the pass-through market inevitably led to innovations especially as originators sought a broader MBS investor base. In response, Fannie Mae issued the first collateralized mortgage obligations (CMO) in 1983. A more complicated twist on pass-throughs, CMOs redirect the cash flows of trusts to create securities with several different payment features. The central goal with CMOs was to address prepayment risk—the main obstacle to expanding demand for pass-throughs. Prepayment risk for MBS investors is the unexpected return of principal stemming from consumers who refinance the mortgages that back the securities. Homeowners are more likely to refinance mortgages when interest rates are falling. As this translates into prepayment of MBS principal, investors are often forced to reinvest the returned principal at a lower return. CMOs accommodate the preference of investors to lower prepayment risk with classes of securities that offer principal repayment at varying speeds. The different bond classes are also called tranches (a French word meaning slice). Some tranches—CMOs can include 50 or more—can also be subordinate to other tranches. In the event loans in the underlying securitization pool default, investors in the subordinate tranche would have to absorb the loss first.

As part of the Tax Reform Act of 1986, Congress created the Real Estate Mortgage Investment Conduit (REMIC) to facilitate the issuance of CMOs. Today almost all CMOs are issued in the form of REMICs. In addition to varying maturities, REMICs can be issued with different risk characteristics. REMIC investors—in exchange for a higher coupon payment—can choose to take on greater credit risk. Along with a simplified tax treatment, these changes made the REMIC structure an indispensable feature of the MBS market. Fannie Mae and Freddie Mac are the largest issuers of this security.

Asset-Backed Securities

The first asset-backed securities (ABS) date to 1985 when the Sperry Lease Finance Corporation created securities backed by its computer equipment leases. Leases, similar to loans, involve predictable cash flows. In the case of Sperry, the cash flow comes from payments made by the lessee. Sperry sold its rights to the lease payments to an SPV. Interests in the SPV were, in turn, sold to investors through an underwriter.



Source: The Bond Market Association

Since then, the market has grown and evolved to include the securitization of a variety of asset types, including auto loans, credit card receivables, home equity loans, manufactured housing loans, student loans and even future entertainment royalties. Credit card receivables, auto and home-equity loans make up about 60 percent of all ABS. Manufactured housing loans, student loans and equipment leases comprise most of the other ABS. And the industry continues to look for new assets to securitize such as auto leases, small-business loans and "stranded cost recovery" ABS. (The latter refers to bonds backed by fees some newly deregulated utilities have won authority to include in future billings as an offset of previous investment.)

How Securitization Works

ABS and MBS represent an interest in the underlying pools of loans or other financial assets securitized by issuers who often also originate the assets. The fundamental goal of all securitization transactions is to isolate the financial assets supporting payments on the ABS and MBS. Isolation ensures payments associated with the securities are derived solely from the segregated pool of assets and not from the originator of the assets. By contrast, interest and principal payments on unsecuritized debt are often backed by the ability of the issuing company to generate sufficient cash to make the payments.

Origination and Servicing

The assets used in securitizations are created—or originated—in a number of ways. When a lender extends a loan or acquires another revenue-producing asset such as a lease, they are creating assets that can be securitized. Other assets, such as the balances due on credit card accounts or a corporation's accounts receivable can also be securitized. Because they initiate the securitization chain, the lenders, credit card companies and others are also called originators. Originators often retain a connection to their assets following a securitization by acting as a servicer—the agent collecting regular loan or lease payments and forwarding them to the SPV. Servicers are paid a fee for their work. Some originators contract with other organizations to perform the servicing function, or sell the servicing rights.

Asset Transfer or the "True Sale"

In the vast majority of securitizations, it is critical that the transfer of assets from the originator to the SPV is legally viewed as a sale, or "true sale." The proceeds of the securities are remitted to the originator as the purchase price for the assets. If the asset transfer is not a "true sale," investors are vulnerable to claims against the originator of the assets. The cash flows backing the securities or the assets themselves could be ruled a part of the originator's estate and used to satisfy creditors' claims if a true sale did not occur. Legally separating the assets also protects the originator.

Investors can turn only to the SPV for payments due on the ABS and MBS, not to the general revenues of the originator.

Special Purpose Vehicle and the Trust

The SPV can either be a trust, corporation or form of partnership set up specifically to purchase the originator's assets and act as a conduit for the payment flows. Payments advanced by the originators are forwarded to investors according to the terms of the specific securities. In some securitizations, the SPV serves only to collect the assets which are then transferred to another entity—usually a trust—and repackaged into securities. Individuals are appointed to oversee the issuing SPV or trust and protect the investors' interests. The originator, however, is still considered the sponsor of the pool.

Underwriter

Underwriters—usually investment banks— serve as intermediaries between the issuer (the SPV or the trust) and investors. Typically, the underwriter will consult on how to structure the ABS and MBS based on the perception of investor demand. The underwriter may, for example, advise the SPV to issue different tranches each with specific characteristics attractive to different segments of the market. Underwriters also help determine whether to use their sales network to offer the securities to the public or to place them privately. Perhaps most importantly, underwriters assume the risk associated with buying an issue of bonds in its entirety and reselling it to investors.

Credit Enhancement

Credit enhancement is common in securitization transactions. Depending on the nature of the transaction and the type of assets, the securitization pool may need such support to attract investors. Enhancement or support can come from the assets themselves or from an external source. Examples of internal enhancements include subordinating one or more tranche, or portion, of the securities issued. This practice places the claims of one tranche over another. Any defaults affecting the securities must be absorbed by a subordinate tranche before the senior tranche is affected. Over-collateralization of asset pools is also used to enhance credit. This occurs when the amount of assets placed in a securitization pool exceeds the principal amount of bonds issued.

External credit enhancements can include a surety bond or a letter of credit from a financial institution. Both options serve as guarantees that investors will receive the payments associated with the securities. GSEs enhance the credit of the MBS they issue by guaranteeing the timely repayment of principal and interest.

Credit Rating

Virtually all ABS and MBS are rated by independent rating agencies whose analyses is watched closely by investors as a guide to the credit quality of the securities. In almost all cases, rating agencies monitor the performance of the securities on an ongoing basis.

Dealers

Just as in other bond markets, dealers play an important role once an issue is initially distributed. For most bond investors, liquidity—the ability to easily buy or sell a security—is an important characteristic. By offering prices at which they will buy or sell bonds to the investment community, dealers provide this service. Bonds typically trade more actively closer to their date of issue. Because bond investors—usually institutional investors such as pension funds and insurance companies—hold most bonds to maturity, trading in bonds declines as they draw nearer to their stated maturity date. The issuance volume of a certain bond, a bond's credit rating and whether it was issued publicly or privately can also affect liquidity. All ABS and MBS are traded on the dealer-based, over-the-counter markets so liquidity depends in part on the ability and willingness of dealers to maintain an inventory, or make a market, in a certain bond.

Benefits of Securitization

Less Expensive, More Broadly Available Credit

The public benefits of securitization are evident in a number of ways. Chief among these is the contribution of securitization to lower borrowing costs both for individuals and corporations. The existence of a liquid secondary market for home mortgages increases the availability of capital to make new home loans. Financial institutions that realize the full value of their loans immediately can turn around and re-deploy that capital in the form of a new loan. This is often the most efficient way to raise new funds in the capital markets and the savings are passed on to the borrower.

Consumers other than homebuyers also benefit from lower borrowing costs. Securitization can lower a firm's financing costs as well. MBS and ABS are often designed to carry a higher credit rating than the originating firm would otherwise realize for other types of bonds. Higher credit ratings mean the security is less risky and translates into a lower interest rate for the originator as investors do not demand the same risk premium. The originator passes the savings on to the consumer in the form of lower lending rates.

Securitization also aids in the geographic dispersion of capital to areas that may otherwise be deprived of credit options. Traditionally, depository institutions have provided credit in the areas where they accepted deposits. By securitizing loans, however, the lender generates capital for new loans that may come from a different location. This linkage to the capital markets broadens the range of regions where depository institutions obtain capital to provide credit.

By subjecting the lending decisions of financial institutions to valuation by the capital markets, securitization also encourages an efficient allocation of capital. Financial institutions and others who securitize assets depend, of course, on investors. Investors seek an appropriate return based on a level of risk. If the asset pools are not of a sufficient quality, for example, investors will demand a higher interest rate as compensation. At its most basic level, securitization is the process of isolating risk and repackaging it for investors. This increases efficiency in the capital market by removing intermediary steps between investors and the risk they are assuming. A money manager, for example, may be interested in a mortgage-backed bond that pays interest and principle on a monthly basis, but not in the debt securities issued by the originator of the securitized assets.

Securitization reallocates risk at many levels. By shifting the credit risk of the securitized assets (for a price) to ABS and MBS investors, financial institutions can reduce their own risk. As the risk level of an individual institution declines, so does systemic risk, or the risk faced by the financial system overall.

More Options for Investors

As noted above, investors benefit from the legal segregation of the securitized assets. The segregation protects the payment stream on the MBS and ABS from a bankruptcy or insolvency. Higher-rated securitized instruments generally offer higher yields than similar sovereign government issues. The actual size of this yield premium, the yield the securities pay in excess of similar government securities—will depend on the credit quality of the assets and the structure of the transaction. Pension funds—which comprise much of the market for MBS and ABS—pay close attention to this premium as they seek a wide variety of safe fixed income products with attractive yields. Insurance companies, money managers and other institutional investors with needs for fixed-income securities with specific features are also large ABS/MBS investors.

The ability of issuers to vary the terms of securities backed by the same asset pool through different securitization techniques also makes MBS and ABS attractive to investors. In a sense, issuers can tailor the coupon, maturity and seniority of a security according to particular investor's needs. This flexibility not only boosts investor interest in ABS and MBS, but also contributes to more efficient capital markets by ensuring investors and money managers have access to the most appropriate securities.

Flexibility for the Originator

Securitization also benefits the financial institution or corporation that originates the securitized asset. Without securitization, a bank making a home loan usually would hold that loan on its books, recognizing revenue as payments are made over time. To realize the value of the loan immediately, the bank can sell the whole loan to another institution, though this is generally not economical unless the loan is very large. The more efficient option is to pool similar loans together, as discussed above, and enter into a securitization transaction.

The process makes even more sense for originators with assets considered illiquid, such as equipment leases or the balance due on a credit card. The latter comprises an asset class called credit card receivables that account for approximately 20 percent of outstanding ABS. Similar to banks securitizing home loans, credit card companies are able to use the securitization process to provide more credit and manage their balance sheets.

Originators realize another benefit from securitization as the transfer of the asset to an SPV removes it from the firm's balance sheet. This can help the originator improve certain measures of financial performance such as return-on-assets (ROA). A way to gauge a firm's efficiency, ROA tells observers how many dollars are earned for every dollar of assets. Moving an asset off of the balance sheet while simultaneously increasing income has a positive effect on ROA and demonstrates to investors a more efficient use of capital. Banks realize a unique advantage from securitization. Removing loans from their balance sheet can lower regulatory capital requirements, or the amount and type of capital banks must hold given the size of their loan portfolio, to reflect lowered risk.

The segregation of assets that takes place in a securitization can also effectively lower the firm's financing costs. This occurs when the securities issued by the SPV carry a lower overall interest rate than the originating firm pays on its debt. As the firm receives the proceeds from the securitization it has, in effect, achieved cheaper financing than might have been extended to the firm based solely on its own credit rating.

Conclusions

Securitization reflects innovation in the financial markets at its best. Pooling assets and using the cash flows to back securities allows originators to unlock the value of illiquid assets and provide consumers lower borrowing costs at the same time. MBS and ABS securities offer investors with an array of high quality fixed-income products with attractive yields. The popularity of this market among issuers and investors has grown dramatically since its inception 30 years ago to $6.6 trillion in outstanding MBS/ABS today.

The success of the securitization industry has helped many individuals with subprime credit histories obtain credit. Securitization allows more subprime loans to be made because it provides lenders an efficient way to manage credit risk. Efforts to curb "predatory" lending that inhibit the legitimate use of securitization by assigning liability to the purchaser of a loan or some other means, threaten the success of the beneficial subprime market. Secondary market purchasers of loans, traders of securitized bonds and investors are not in a position to control origination practices loan-by-loan. Regulation that seeks to place disproportionate responsibilities on the secondary market will only succeed in driving away the capital loan purchasers provide in the subprime market.

I urge Congress to move with great care as it addresses the problem of predatory lending. The secondary markets are a tremendous success story that has helped democratize credit in this country. Well intended, but overly restrictive, regulation in this area could easily do more harm than good. This is particularly the case when state and local governments craft disparate anti-predatory lending statutes that place different compliance burdens on the secondary market. For this reason, the ASF urges this committee to consider legislation to pre-empt the authority of state and local governments in the area of predatory lending and to construct a safe harbor from assignee liability for secondary market participants.

Thank you again for the opportunity to testify today.

Testimony
before the

Subcommittee on Housing and Community Opportunity

and

Subcommittee on Financial Institutions and Consumer Credit

at Joint Hearing regarding

"Protecting Homeowners: Preventing Abusive Lending While Preserving Access to Credit"

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Introduction

I am Kurt Eggert, an Associate Professor of Law at Chapman University School of Law in Orange, California, where I teach real estate transactions and elder law. I have written several articles on predatory lending, and have frequently spoken on this subject in panels at the American Bar Association's annual meeting, the Association of American Law Schools, and several symposiums and conferences.

My testimony today will focus on the importance of having assignee liability for residential mortgages. Although my testimony today will focus on this one aspect of the predatory lending problem, I will also be putting into the record the entire text of a full law review article I authored entitled Held Up In Due Course: Predatory Lending, Securitization, and the Holder In Due Course Doctrine, which appeared in volume 35 of the Creighton Law Review in April, 2002. In that article, I describe the securitization of home mortgages and discuss how that securitization has fostered predatory lending in the United States by giving unscrupulous lenders a ready secondary market for their overpriced loans. I discuss the interaction of securitization and the holder in due course doctrine, which prevents a homeowner from bringing most of her defenses or claims regarding the origination of a loan against the assignee of a loan and so prevents assignee liability in many cases. Much of my testimony today is based on that article.

In my testimony today, I will propose a definition for the term "predatory lending" and then describe common tactics used by abusive lenders. Next, I will address how the securitization of residential mortgages, pooling them and selling securities based on the pool on Wall Street, has led to a dramatic increase in subprime and predatory loans. Then I discuss a solution to this securitization-driven epidemic of abusive lending: force the investors who buy interests in the loan pools to bear the risk of predatory loans in those pools. If investors bear this risk, then they will demand that the securitizers of those loans ensure that the originators of the loans have abstained from predatory behavior and are creditworthy enough to repurchase any predatory loans. I argue that securitizers, with their greater market savvy and informational advantages, are better equipped than borrowers to recognize predatory lending and to refuse to deal with the abusive lenders that engage in it. Denied access to the capital markets that have purchased their loans and financed their activities, unscrupulous lenders will have difficulty funding loans.

I hope to dispel several myths about predatory lending, such as the notion that predatory lending has not been or cannot be defined, and until it is defined, no action should be taken to prevent it. Another myth is that the secondary market and other assignees cannot easily tell which loans are predatory and that individual borrowers are better able to prevent predatory lending. I would also like to dispel the notion that the securitization of mortgages is an unadulterated benefit for borrowers and must be preserved at all costs, even at the risk of having individual borrowers lose their homes because of predatory lending. Instead, it appears that securitization may not lower mortgage costs for subprime borrowers and may even increase those costs.

I will also discuss the current battle over assignee liability, during which the lending industry is claiming that assignee liability makes it difficult, if not impossible, to securitize residential mortgages. Rather than making such securitization impossible, assignee liability will, if designed correctly, cause ratings agencies to scrutinize the origination practices and creditworthiness of the originators of loans. This increased scrutiny will help deter originators that depend on securitization to fund their lending from engaging in predatory practices. Ensuring the creditworthiness of the lenders will help ensure that if the lenders do engage in predatory behavior, they will have sufficient assets to repurchase the affected loans, so that the borrower will be able to sue them directly without concern for the cutting off of any of their defenses. In addition, originators that are creditworthy are less likely to declare bankruptcy and so borrowers who have been defrauded are more likely to be able to recover their damages against the originator.

"Predatory Lending": Definition and Techniques

While predatory lending has been the focus of many hearings, articles, laws, and regulations, there has not yet been one generally accepted definition for this term. Opponents of laws attacking predatory lending assert that in the absence of a clear, generally accepted definition of predatory lending, any such efforts are premature. However, I believe that a clear, concise definition of predatory lending is possible. Clearly, predatory lending implies some abusive process whereby lenders take advantage of borrowers, and some definitions focus on the exact methods the lenders use. However, a more accurate definition should focus on both the coercive process and the detrimental effect of the lending, weighing one with the other to determine whether the lender has gained an unfair advantage over the borrower. Therefore, I offer this definition:

"Predatory lending" is the use by lenders of deceptive, manipulative, or coercive practices in order to induce borrowers to accept loans that (1) have interest rates or fees significantly above the current market rate given the risk profile of the borrowers or other terms significantly worse than the market norm offered by legitimate lenders, or (2) which leave the borrowers worse off than they would have been without any new loans, or (3) both. These factors should be balanced against each other so that a loan with grossly excessive interest rates or fees, given the risk characteristics of the borrower, would need less in the way of lender deception, manipulation, or coercion to be considered predatory.

A loan may affirmatively harm a borrower whether or not the loan is overpriced where, for example, the borrower is likely to be unable to repay the new loan and will lose her house as a result, or where it refinances existing loans with interest rates below the current market rate. Most loans that significantly increase the chances of foreclosure, for example, would likely be predatory regardless of their price, because foreclosure is so harmful to borrowers. However, the primary goal of predatory lenders is to convince or coerce borrowers to obtain loans that cost more than the market rate given the borrowers' risk characteristics.

Common methods of inducing borrowers to pay higher than market interest rates or fees or accept affirmatively harmful loans include:

1) Loan Flipping: The rapid refinancing of borrowers' loans, adding new fees and costs to each refinancing so that the lender bleeds dry the equity in the house. Flipping appears to be widespread in the subprime market for loans to elder borrowers.

2) High Prepayment Penalties: These fees for paying loans off early are rare in the prime market, but run rampant in the subprime market. Many subprime lenders charge prepayment penalties as high as five percent of the loan if borrowers prepay their loans.

3) Equity Stripping: The process of convincing homeowners to enter into loans that cause them to lose their homes when they cannot pay the loans.

4) Packing: The process of increasing the amount of loans by adding unnecessary charges for products, such as credit insurance, that the borrower does not need, want, or often even realize that she is purchasing.

5) Steering: The process by which loan brokers direct borrowers to lenders who will provide high-cost loans, even though the borrowers would qualify for much lower interest rates. Steering by brokers is so effective that perhaps thirty-five to fifty percent of borrowers induced into accepting subprime loans could have qualified for much less expensive prime rate loans.

6) Balloon payments: The requirement that the borrower pay the entire loan amount before the monthly payments would have gradually paid off the loan. Some abusive lenders include this requirement to ensure that their borrowers, who rarely can make such a large lump-sum payment, must refinance their loans, offering a new opportunity for the lender to charge points and fees, thus increasing the amount of the loans.

7) Fraud or Deception: Outright deception is the most blatant form of predatory lending and may occur either through express statements or by concealing information from borrowers that would reveal the true cost or effects of the loan.

Predatory lending harms not only its victims but also their communities. Its victims are burdened with overpriced mortgages and, even if they are able to pay these loans, they feel the financial loss for years afterward. This direct cost was recently estimated at $9.1 billion annually. This figure, high as it is, does not include the much greater and separate harm of foreclosure suffered by those unable to pay their loans.

While abusive lending has always existed, there seems to have been an explosion of particularly virulent lending abuses in the 1990s. In case after case, a new or small lender would suddenly grow at an enormous rate, while accusations of the lender's abusive practices would grow at the same time. Then, even more quickly than it grew, the lender would disappear, filing for bankruptcy protection and leaving the victimized borrowers to fend for themselves against the current holders of their mortgages. These current holders could argue that, as innocent assignees of the notes, they should hold the notes free of almost all defenses that the borrowers had against the original lenders, including most fraud claims.

How these lenders could grow so quickly beginning in the 1990s is no mystery. Wall Street investment bankers discovered they could profit greatly from subprime loans, by lending money to subprime lenders and by taking sizeable fees for securitizing the resulting loans. With this ready flow of capital from Wall Street, subprime lenders could grow dramatically, lending far more each year than they might have had they held their own notes or tried to sell the notes individually to private investors.

The Process of Securitization

To understand Wall Street's role in the growth of subprime and predatory lending, one must first understand the process of securitization. Securitization is the method of aggregating a large number of notes secured by deeds of trust, or other illiquid assets, in a large pool, and then selling securities backed by those assets. These securities trade on an open market and allow investors to buy interests in the pool of notes without the paperwork or risk of purchasing individual notes. The resulting securities are highly liquid and easy to trade. Securitization has transferred the source of capital for mortgage funding from the savings industry to the capital markets and institutional and other investors. The process of securitization is designed to isolate the notes from the entity that originated them or acquired them, so that the notes are legally completely independent from their former owner and as free as possible from bankruptcy or liability risks of the originator.

A typical securitization of a loan secured by a residence might proceed as follows. The borrower negotiates with a mortgage broker for the terms of the loan. Mortgage brokers may originate the loans in their own names in three ways: (1) by using "table funding," money provided by the pre-arranged buyer of the loan used to close the loan in the originator's name; (2) by access to a warehouse line of credit; or (3) by supplying the broker's own funds. Alternatively, the mortgage broker may close the loan in the name of the lender providing the money. Whether the broker closes the loan in his or her own name or in the name of the lender, the broker typically almost immediately transfers the loan to a lender. This lender quickly sells the loan to a different financial entity, which pools the loan together with a host of other loans in a mortgage pool. The loans in the pool may all come from one lender or from a multitude of lenders.

The assignee of the loans then transfers them to another entity, typically a limited liability company or wholly owned corporate subsidiary. This entity (known as the "seller" because it will sell the securities that result from the securitization process) then transfers the loans to a special purpose vehicle (an "SPV"), a business entity that has the sole purpose of holding the pool of mortgages, and in return the seller receives the securities issued by the SPV. SPVs can be trusts, corporations, limited partnerships, or more specialized business entities, though a trust is considered the most common. However, the set of fiduciary duties that trust law would normally impose are by and large replaced by the trust agreement's minutely detailed provisions.

The securities that the SPV transfers to the seller are carefully packaged to maximize their appeal to purchasers. There are a multitude of ways in which these securities can be packaged, as different aspects, or "strips," of the loans are divided up and sold separately as securities. A relatively simple, straightforward division of ownership rights in the pooled loans is for one group of securities to represent the interest that will be paid on the loans (interest-only strips), and a second group to represent the repayment of principal on those same loans (principal-only strips). If interest rates drop, the prepayment rate of the loans in the pool normally increases, shrinking the income of the holders of interest-only strips, since there will be fewer loans to pay interest, while swelling the returns of the principal-only strips, as they receive the payments on principal years before the payments might have been expected. The pool of mortgages can be cut into much more complex strips of mortgages, depending on what the creator of the SPV thinks may be most easily sold. The strips, or classes of securities, are also called "tranches," which is French for "strips."

Working with the seller to package the loan pool and its resulting securities is an underwriter, which, together with a rating agency, examines the loans assembled in the pool, sets specific requirements of loss probability for the loans, and discards loans that do not meet the risk standards set for the pool, returning them to the originator. The intermediaries who pool mortgages, however, have been too reluctant to undertake any significant diligence in their own examination of the loans or the borrowers and instead have excessively relied, for the most part, on detailed representations by the originators of the loans.

Most pooling agreements give the intermediaries the right to force an originator to take back any loan that did not actually qualify for the loan pool, the inclusion of which would cause a breach of the originator's representations. Therefore, the originator of the loans may be forced to take back a loan if the borrower defaults. Once the securities are rated by the rating agency, they can be sold to investors. This sale is typically accomplished by private placements or by public offerings, and an underwriter is involved in all public offerings and most private placements. The buyers may include mutual and pension funds, insurance companies, other institutional investors, and private individuals.

Securitization and its Discontents

The lending industry claims that securitization is an unqualified boon to borrowers as it lowers their interest rates and allows the free flow of money to home mortgages. While the government sponsored entities (GSEs) that securitize loans, such as Fannie Mae and Freddie Mac, claim that their securitization has led to lower interest rates, a recent analysis by the Federal Reserve Board suggests that securitization may not decrease interest rates. Instead, falling interest rates may lead to increased securitization by GSEs, rather than the other way around, and the liquidity premium that securitization creates may not be passed along to the borrower.[1]

Another analysis of the effects of securitization concluded that, rather than decreasing the costs of borrowing, securitization may actually increase those costs, so long as the originators of loans have better information regarding the actual risk characteristics of the borrowers than do the securitizers of the loans and the securitizers have a comparative advantage in guaranteeing loans. This price increase would be due to the "lemon effect," the fact that securitizers may fear that originators will transfer their worst loans (the "lemons") to the securitizers while retaining their best loans (the "cherries") for the originators' own portfolios. Originators may doubt whether the risk characteristics of the possible lemons is as good as claimed by originators, and so demand a higher interest rate from the borrowers than they would if they had more perfect knowledge of the risk characteristics of the loans. Also, securitizers may offer a higher guaranteed rate of return across the boards for the loans

[1] See Andrea Heuson, Wayne Passmore, & Roger Sparks, Credit Scoring and Mortgage Securitization: Do They Lower Mortgage Rates? Federal Reserve Board Paper 2000_44, Dec. 12, 2000, at http:// www.federalreserve.gov/pubs/feds/2000/200044/200044abs.html. Unsurprisingly, the GSEs have attacked the Heuson, Passmore and Sparks paper, arguing that it is based solely on a model of "a hypothetical mortgage market based on a flagrantly unrealistic assumption," and "contains not one shred of data or evidence." Mike Sorohan, Securitization Does Not Lower Rates, Fed Report Says, Real Est. Fin. Today, Dec. 12, 2000, 2000 WL 8249712.

to induce the originators to sell all of their loans, "cherries" as well as "lemons."[2]

Securitization might not only increase subprime borrowing costs, it may cause other harms to borrowers. First of all, securitization has encouraged the decline of stringent underwriting. Careful underwriting reduces foreclosure against borrowers by deterring lenders from making loans to borrowers unable to repay the loan.[3] As originators immediately sell their loans and so face less risk of loss even if a borrower defaults, the originators naturally will spend less time and effort screening potential loans for default, thus increasing the risk of lending money to borrowers with a high level of default risk. Securitization reduces the amount of individual, lender-driven underwriting and instead depends on systemic controls that can be objectively verified, such as automated underwriting systems. 98 percent of mortgage companies now use some form of automated underwriting, according to a 2001 survey.[4] In this way, banks step away from their great strength, which was the effectiveness and efficiency of their information gathering and regulation systems, in both selecting which loans to make and controlling those loans once made, and in using their long-term relationships with borrowers.[5] With less lender supervision, borrowers are more likely to default on their loans and risk foreclosure, though the default and foreclosure would likely occur after the original lender has assigned the loan.

<u>Securitization and the "Atomization" of the Residential Loan Industry</u>

Securitization has accomplished what is known as the unbundling of the loan industry, disassembling the lending process into its constituent elements, and allowing a separate entity to undertake each element. Traditionally, lenders performed all of the functions of a loan, finding the borrowers, preparing the documentation for the loan, funding the loan, holding the mortgage during the course of the loan, and servicing the loan throughout its life. Securitization has, in the words of Michael G. Jacobides, "atomized" this process, so that one distinct entity, more often than not a mortgage broker, originates the loan, while another,

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[2] See Wayne Passmore & Roger Sparks, Putting the Squeeze on a Market for Lemons: Government_Sponsored Mortgage Securitization, 13 J. Real Est. Fin. & Econ. 27 (1996) (arguing that where there is information asymmetry between the originator and the securitizer, the securitization process may actually increase interest rates). In their later study, Heuson, Passmore, and Sparks assume that new credit scoring approaches have largely eliminated this information asymmetry in the prime market, though originators still have the "first mover advantage" of deciding what loans to securitize. However, in the subprime market, automated credit scoring has not been as universal or as efficient. Because subprime borrowers are more heterogeneous than prime borrowers, automated scoring systems are faced with a greater variety of potential risk characteristics. This, with the additional element of originator fraud, which is more common in the subprime market, preserves the information asymmetry between the originators and the securitizers, despite the advent of automated credit scoring.

[3] Edward L. Pittman, <u>Economic and Regulatory Developments Affecting Mortgage Related Securities, 64 Notre Dame L. Rev. 497, 546 (1989)</u>.

[4] Chris De Reza, Fannie Mae, Freddie Mac Agree to Common AU Standard, Real Est. Fin. Today, Elec. Ed., July 23, 2001, at 1, <u>2001 WL 8193092</u>.

[5] Elisabetta Montanaro, Efficient Risk Management in Financial Systems: Universal Bank or Securitisation, in The Recent Evolution of Financial Systems 128 (Jack Revell ed., 1997).

perhaps a mortgage banker, funds the loan, and another may securitize the loan and sell it to investors.[6] These investors, through their ownership of securities issued by the SPV holding the mortgage in trust with a pool of other mortgages, claim the capital represented by the mortgage, while a separate set of entities, such as a master servicer and subservicer, under the trustee's direction, services the loan, accepting the mortgage payments and foreclosing if necessary.

This separation of the mortgage process confers on each entity in the chain a plausible deniability of the actions of the others. The securitizer can claim to be unconnected to the broker and unaware of any of his activities, however improper. The SPV and the owners of its securities can claim to be holders in due course and protected from any accountability for the fraud of the mortgage broker, through their ignorance of any such fraudulent behavior. The mortgage broker can accurately claim, once the loan is out of his hands, that he can no longer help the borrower if the servicer wrongfully attempts to foreclose.

Before the rise of securitization, borrowers dealt with large finance companies, which funded their own loans and held the loans in their own portfolios. Because these lenders continued to hold the borrowers' paper, were closely regulated, and were required by regulators to hold sizeable assets, the finance companies had diminished incentive to commit outright fraud against the borrowers, as borrowers retained any defenses they had to the loans and the borrowers could also seek damages against the finance companies. With the rise of securitization, the origination of mortgages has largely been turned over to mortgage brokers, who now originate over sixty percent of all residential loans in the United States. Mortgage brokers are less regulated than finance companies and less constrained, since they may have few assets, either in their company or individually and rarely continue to hold the loans they originate.

While mortgage brokers themselves have very little direct interaction with the secondary market, the brokers often originate loans for the wholesale lenders, who then sell them onto the secondary market. A wholesale lender might purchase loans from a thousand different independent brokers and bankers from around the country. This use of brokers may lead to higher fees charged to borrowers, as brokers could be tempted to seek out the lenders that provide the greatest payments to brokers rather than the best rates to borrowers. Also, because brokers' fees are commonly a percentage of the total loan, brokers have an incentive to encourage the borrowers to take out as large a loan as possible, to maximize the brokers' commissions, even if a smaller loan would be more appropriate for the borrowers. The use of brokers has hastened the growth of subprime lending. Some brokers have steered borrowers who would qualify for conventional loans into subprime loans, since the brokers make greater fees from subprime than prime loans.

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[6] Michael G. Jacobides, Mortgage Banking Unbundling: Structure, Automation and Profit, Mortgage Banking, Jan. 1, 2001, 2001 WL 11398425. Jacobides writes, "The mortgage banking industry is one of the most fascinating examples of vertical disintegration and reconfiguration in modern business history." See Tamar Frankel, Securitization: The Conflict Between Personal and Market Law (Contract and Property), 18 Ann. Rev. Banking L. 197, 202 (1999) for the stages of the securitization process.

The securitization process allows even someone with almost no capital or financial services to exploit this lack of regulation and become a lender or otherwise originate loans. A mortgage broker could easily be judgment-proof in the states that do not require them to be bonded or to maintain a minimum capital. Such mortgage brokers are free to disappear if they are sued. Disreputable brokers have been known to declare bankruptcy, move to another state, and begin business anew under assumed names. Furthermore, since mortgage brokers rarely hold a borrower's notes in their own portfolios, they have too little reason to be concerned about any defenses the borrower might have to the note.

Securitization removes one sometimes potent weapon in the hands of a borrower who needs to have her loan restructured. When loans were held by regional or local banks, those banks were susceptible to bad publicity and might be loath to foreclose on the home of, for example, an elderly borrower, especially one who was the victim of fraud. Banks have locally recognizable brand names, so that borrowers can threaten to picket a bank or bring discredit to the brand name unless the bank acts reasonably in helping borrowers resolve their problems. Banks also might have some interest in keeping their customers satisfied, with an eye to obtaining repeat business from the customer or new business from referrals.

Securitization, on the other hand, has allowed the markets to be unbundled, atomizing the mortgage origination and collection process. When a mortgage broker solicited the borrower, an SPV holds the loan, and a servicer collects the payments, who would a defrauded borrower picket in order to obtain a loan forbearance? The originator may be long gone, as many subprime lenders have in recent years declared bankruptcy and gone out of business. The SPV is a business entity whose sole purpose is to hold a mortgage pool, and is completely immune from any threats to its good name, which is often something like "Security Pool #351." The servicer is similarly immune to threats or pleading, as it serves solely at the direction of the trustee. The servicer little depends on the happiness or good will of the homeowners who make payments to it, since the homeowners have no choice whatsoever regarding which servicer collects the payments on their loans. Servicers have so taken advantage of borrowers on occasion of late that the term "predatory servicing" has been added to that of "predatory lending." The trustee also does not need to keep the good will of the borrowing public, since it gets its business from originators, not the borrowers. A reputation as a particularly ruthless collector of debts might well aid the trustee or servicer in gaining new originator clients. Furthermore, the trustee and servicer can always claim to be bound by the foreclosure criteria contained in the initial offering of the securities and absolve themselves of any responsibility to exercise discretion in dealing with a desperate homeowner.

The parties to the securitization who may most be affected by bad publicity are the underwriters, large Wall Street firms that should want to avoid tying their firms' valuable reputation to predatory lending. While Wall Street firms might avoid individual firms linked to predatory lending (though their support of predatory finance companies throws even that supposition into doubt), they did continue to participate in the securitization of residential loans without attempting to root out fraudulent lenders despite widely publicized hearings in

1994 and 1998 that documented how many lenders were taking advantage of unsophisticated borrowers and that the problem was growing dramatically.

The Holder in Due Course Doctrine and the Need for Assignee Liability

One pernicious effect of securitization is that it encourages the most rapid creation of an assignee with holder in due course status by causing the originator of the loan to sell the loan almost immediately. The holder in due course doctrine provides that if one who is assigned and holds an instrument is not chargeable with knowledge of or participation in certain wrongful acts, then most of the defenses that the maker of the note (the borrower) had to the original beneficiary of the note (the original lender) cannot be used against the new holder (the assignee). The cutting off of defenses upon transfer to a holder in due course has long been considered the central element of negotiable instruments. The holder in due course doctrine prevents assignee liability, which is the liability that the current holder of a note would have toward a defrauded or otherwise victimized borrower based on the actions of the original lender on the note.

The holder in due course doctrine does not cut off all defenses that a borrower or maker of the negotiable instrument, such as a promissory note, might have. The few defenses that remain to the maker of the instrument are the so-called "real defenses," which include infancy, duress, lack of legal capacity, illegality of the transaction, discharge of the obligor through bankruptcy, and fraud causing the drawer of the instrument not to know, for reasons that were not her fault, the nature of the instrument she was signing. The "real defenses" are rare and fairly difficult to prove. Among the defenses that are cut off when a note is transferred to a holder in due course, called the "personal defenses," are the more common and easier to prove claims, such as: (a) that the borrower, while not completely incompetent, was less than fully competent; (b) that while she knew that she was signing a note and deed of trust, misrepresentations were made to her regarding its terms or effects or other conditions; (c) that undue influence had been used to coerce her into signing the note.

The holder in due course doctrine historically had two primary functions, both of which can now be better performed by other means. One function was to create a currency substitute, greatly needed in the seventeenth and eighteenth centuries when there was insufficient currency and inadequate means to transport that currency for the economy of the day. The usefulness of negotiable instruments as a currency substitute disappeared by the mid-nineteenth century.

Another function of the holder in due course doctrine was to make negotiable instruments more easily transferrable by removing a great barrier to their transferability, the fear that the maker of a note would have a defense to it. The holder in due course doctrine is intended to increase the liquidity of notes and thus their usefulness to commerce. This function of the holder in due course has, at least as far as residential or consumer loans, been taken over by the securitization of those loans, which provides greater liquidity than did the holder in due course doctrine. The holder in due course doctrine lives on in residential loans, those secured by the residences of the borrowers, long after its legitimate purposes have disappeared or been replaced by other tools.

Before the days of securitization, when lenders often held the notes they originated for the life of the loans, the holder in due course doctrine and the question of assignee liability were not as important, as there were far fewer assignees of notes. Gone, however, are the days when a lender would normally hold the loan for its full term. Instead, lenders might hold the loan for a few weeks, assigning it almost immediately either to a GSE or to another securitizer. Often, the loan will be sold before the first payment is even due, so that if the homeowner/borrower learns that her payments are much larger than had been represented to her, that defense has already been cut off as to the current holder of the note by the holder in due course doctrine. This combination (initial loan made by a thinly capitalized, poorly regulated lender who immediately negotiates the loan to a securitizer, so that the investors in the securities can claim holder in due course status) is a recipe for irresponsible and unethical lending, if not outright fraud.

The Secondary Market is Better Equipped to Minimize Predatory Lending Than Are Borrowers.

Both the borrower and the purchaser of the loan can take precautionary steps: the borrower can refuse to respond to subprime lenders' advertising, try to deal only with reputable loan brokers and to read all of the documents presented for her signature, refusing to sign those that she does not understand or agree to, or that do not correspond to the oral representations she has received. The purchasers of loans or securities backed by residential mortgages can investigate the brokers and lenders from whom they buy loans, insisting on dealing only with reputable brokers and lenders and ones with sufficient capital to cover sizeable losses. They can also monitor the complaints and default rates of loans that they have already purchased, and refuse to deal further with brokers and lender where there have been problems.

On the surface, it appears that the borrowers' precautionary measures, because they are so direct, would be more effective at less cost. If a potential borrower refuses to sign an unfair or fraudulent loan then, absent forgery, the loan would not exist to begin with. If a loan securitizer refuses to purchase an unfair loan from a dishonest originator, that securitizer's action does not prevent the originator from attempting to sell the loan elsewhere or attempting to collect on the loan itself.

On closer examination, however, it is clear that the borrowers' attempts at precaution might be feeble at best, while the buyers of loans on the secondary market can take inexpensive yet effective measures to reduce the general incidence of unfair loans. A subprime borrower's efforts to avoid deceptive loans by dealing only with large, reputable lenders, could easily come to naught, as some of the largest subprime lenders have been charged with fraud and deception in making subprime loans. Nor are the borrower's efforts to avoid deception by reading the loan documents carefully likely to bear fruit, as the documents are so complex and confusing for the borrower that an unscrupulous lender can easily insert unfair terms in the loan agreement without the borrower's knowledge. While some blame this complexity on the mandated mortgage disclosure forms, much of the complexity of the transaction is inherent in any loan secured by real property, as the presence of a security interest necessarily complicates the transaction well beyond the understanding of most residential borrowers. While the rare borrowers so sophisticated that they understand all the terms of the loan may escape, their escape will not prevent unscrupulous lenders from moving on to their next victims.

By comparison, the secondary market can take effective, long-term, precautionary measures simply by refusing to deal with originators who develop a reputation for sharp practices or deception. If such lenders lose their access to the secondary market and are forced to keep their loans themselves and attempt to collect from their own, often angry, borrowers who retain their defenses to the loan, these unscrupulous originators would have a much harder time growing or even staying in business. The cost to the secondary market of such monitoring would be two-fold. First of all the costs of acquiring information about which brokers and other originators are suspected of illegal or improper practices, and secondly the cost of foregoing the profits to be gained by buying predatory subprime loans that have interest rates above the market rate. This latter cost is not one that even Wall Street is likely to publicly decry. The former cost can be spread out over the entire market. More importantly, the cost of monitoring brokers is already being incurred to good effect by some members of the mortgage industry, and the fruits of that labor can be easily shared with little net cost to the entire lending industry. Therefore, the secondary market has by far the most cost effective means of precaution at its disposal and for this reason should be assigned more of the risk of loss than the borrower.

Clearly, lenders and investors in securitized loans are better able than borrowers to determine the assignment of risk caused by the holder in due course doctrine. Lenders have attorneys, extensive and detailed manuals regarding the law of lending, and their own experience in the lending business. Investors in securitized loans are given detailed disclosure statements that should lay out the risks inherent in their investment.

The typical borrower, especially the typical subprime borrower, on the other hand, is unlikely to be familiar with even the basics of the loan process, which may be the most complicated financial transaction the borrower will ever experience. Unethical brokers target the elderly and undereducated, looking for those even less likely than the average borrower to understand the effects of the loan. Subprime borrowers rarely have the help of an attorney in negotiating a loan secured by residential property, as such advice might cost thousands of dollars. Unscrupulous lenders attempt to separate the borrowers from those who might provide valuable advice, and thus prevent borrowers from becoming more knowledgeable about the loan. Therefore, if the holder in due course doctrine were to assign risk efficiently to the party most likely to discover that assignment of risk and act on it, clearly it should assign such risk to the assignee.

Lenders and investors in securitized loans not only have infinitely greater understanding of the holder in due course doctrine than borrowers, they also have far more information regarding the magnitude of the risk of loss. Lenders can easily determine the going rate of foreclosure among subprime loans, which is one of the primary harms caused by predatory lending.[7] The firms that rate loan securitizations have finely calibrated methods to determine the risk of loss in the pools of loans and disclose that risk to the investors. Servicers can build web pages that allow investors to obtain default rates and other loan performance information. Servicers can give investors access to the information that would help investors detect one of the primary signs of predatory lending, borrowers paying more than market price for loans given their risk profile. Investors can track most of the information on a loan by loan basis they need in order to determine whether the loans are overpriced. They can obtain information such as the credit scores of borrowers, the loan to value ratio of the property, the income of the borrowers. Lenders and underwriters can use sophisticated databases that track fraud and other suspicious activity in residential mortgages, identifying questionable brokers by name.[8] They can identify specific "hot zones," neighborhoods that contain an unusually high incidence of residential foreclosures and are likely breeding grounds of predatory lending. Lenders and underwriters have the help of federal regulators to advise them how to discern warning signs of predatory lending.[9] They can conduct complex analysis of loan pools to see which loans and which lenders are likely predatory.[10] Participants in the secondary market can review loans for signs of potentially abusive terms, including excessive fees and interest rates, balloon payments or prepayment penalties with no corresponding decrease in interest rates for borrowers, and adjustable rate loans that only increase.[11] Because the essence of predatory lending is charging above the

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[7] See Harold L. Bunce, et al., Subprime Foreclosures: The Smoking Gun of Predatory Lending? at http:// www.huduser.org/publications/polleg/hpcproceedings.html.

[8] Beginning in 1995, for example, the Mortgage Asset Research Institute (MARI) has provided a national proprietary database known as the Mortgage Industry Data Exchange (MIDEX) which collects reports of alleged fraud and suspicious incidents and the companies and individuals involved identified by law enforcement or regulators as acting illegally or improperly. See Michele M. Walczak, Mortgage Industry Turns Up Heat on Fraud Artists, Sec. Mortgage Mkts. Online, Oct. 1997, at http:// www.freddiemac.com/finance/smm/oct97/html/oct97.htm. See also Robert Julavits, Industry Stepping Up Efforts to Thwart Loan Fraud, Am. Banker, Feb. 13, 2001, at 11, 2001 WL 3909474. The Mortgage Bankers Association has contracted with MARI for the use of this database. See Predatory Mortgage Lending: The Problem, Impact and Responses: Hearing Before the Senate Comm. On Banking, Housing and Urban Affairs, 107th Cong. (2001) (testimony of John A. Courson, President and CEO, Central Pacific Mortgage Co., on behalf of the Mortgage Bankers Association), available at http://banking.senate.gov/01_07hrg/072701/courson.htm.

[9] See Draft Memorandum from the FDIC Staff, How to Avoid Purchasing or Investing in Predatory Mortgage Loans (November 2000), at http:// www2.fdic.gov/epc/predlend/.

[10] [FN586]. See generally Balvinder S. Sangha & Anne Kerttula, Fair Lending and Predatory Analytics for Lenders, 83 The RMA Journal 66 (2000).

[11] See Comments of the National Consumer Law Center and Consumer Federation of America to the FDIC on Predatory Mortgages, at http:// www.nclc.org/predatory_lending/fdic.html.

market rate for loans, given the credit risk of the borrower, the secondary market participants can spot evidence of predatory lending by comparing the borrowers' credit scores with the loan costs to see if the borrower was overcharged. The secondary market can also monitor the creditworthiness of originators, which decreases the chance that a fly-by-night operation will make numerous predatory loans, then close shop when borrowers begin to sue it.

By comparison, an individual borrower has little comparable access to information on the risk of fraud or whether an individual mortgage broker might be likely to commit fraud. Loan counseling for borrowers has been demonstrated to significantly affect the likelihood that a borrower will become delinquent on their loans. However, the provision of such counseling is uneven and inadequate, and faces further budget cuts. For all these reasons, assigning the risk of fraud to purchasers of mortgage-backed securities would do far more to deter fraud than assigning that risk to borrowers. Lenders and the underwriters and ratings agencies who analyze risk for the investors are much better equipped to determine the risk of that fraud and to minimize that risk by refusing to deal with the unscrupulous mortgage brokers and loan originators likely to engage in fraudulent activities.

The Battle Over Assignee Liability

Both federal and state laws designed to cure predatory lending have recognized the need for assignee liability. However, the lending industry is currently conducting a rear guard action to overturn or limit assignee liability where it can. The federal law which has served as a template for state regulation, the Home Ownership and Equity Protection Act of 1994 (HOEPA), attempts to limit the holder in due course doctrine in high cost loans. Under HOEPA, any assignee of a high cost loan is subject to all of the claims and defenses the borrower could assert against the original creditor, unless the assignee demonstrates that a reasonable person using ordinary due diligence could not determine, based on the required documentation, that the mortgage was a high cost loan.

Some states have followed this pattern, mandating assignee liability for high cost loans. However, this approach has not been universal. California's anti-predatory lending legislation, for example, explicitly provides that it does not impose any liability on holders in due course. And, where states have enacted laws mandating assignee liability, those laws have often been weakened by subsequent legislation or preempted for many lenders by federal regulators. For example, Georgia's predatory lending legislation was greatly weakened by reducing the liability of assignees, amid industry claims that assignee liability would prevent Georgia loans from being securitized. Ratings agencies had refused to rate loans in Georgia, fomenting this legislative change, and appear to be prepared to use the same tactic in other states.

Ratings agencies can rate loan pools even where law provides for assignee liability, however, so long as the laws that create assignee liability do so in a way that allow the ratings agencies to discern the level of risk to assignees that must be disclosed to investors. This ability by ratings agencies to determine the level of risk is affected by how clearly the legislation creating assignee liability delineates which loans are affected by the legislation and how well the ratings agency can determine the size of the potential claim against the assignee of the loan.

Most importantly, once a ratings agency determines that it can rate a loan pool with loans bearing assignee liability, the possibility of such liability causes the ratings agency to increase the diligence of its examination of the seller and its origination activities. At least one ratings agency has announced that it will review originators' compliance procedures to ascertain whether the loan originator can identify loans subject to assignee liability and loans that are predatory, by which the ratings agency means those that violate legislation designed to prevent predatory lending. The ratings agency will also review the creditworthiness of the loan originator to ensure that the originator can repurchase any predatory loan that is discovered in the loan pool. The ratings agency also stated that its review assumes "increased significance" where loans subject to assignee liability are included in the pool and its requirements will be "considerably more stringent" for such pools where there is the increased risk of assignee liability for predatory loans. In other words, the presence of assignee liability, far from harming borrowers, causes the securitizers of loans to guard against the inclusion of predatory loans in their loan pools. If loan securitizers refuse to securitize loans with predatory terms, they will reform the lending practices of originators that depend on securitization of their mortgages.

The newest arena in the battle over assignee liability is that of preemption. Federal banking regulators have argued that states' predatory lending laws should be preempted as to federally regulated banks. Some in the industry have sought federal law that would preempt this state law for all lenders. However, this preemption effort is, at best, premature. New state laws have been drafted all over the country to combat predatory lending. These laws should be given some time to see which work most effectively. In this way, the states' laws can be used as a means to find out what system of regulation most protects borrowers without cutting off valuable access to credit. Stepping in with federal preemption at this early stage will not only trample on the states' interest in protecting their consumers, but will also prevent policy makers from discovering useful lessons from the states' experience. Even in the long term, federal preemption prevents states and locales with a greater incidence of abusive lending from providing increased protection. Thus, cities like Chicago or Oakland, California, which have been hard hit by predatory lending, would not be able to take the additional protective measures their citizens need that those who live in small towns in Kansas might not require.

Conclusion

The securitizers of residential mortgages and other secondary market participants are far better at detecting and deterring predatory lending than are borrowers, and therefore they rather than the borrowers should bear the risk of predatory behavior. To accomplish this transfer of risk requires that assignees be liable for the predatory behavior of the originators of loan and that the holder in due course doctrine be abrogated for residential mortgages.

This assignment of risk will cause those market participants best able to prevent abusive lending to use the means already at their disposal to prevent it.

Consumer Federation of America

TESTIMONY OF

ALLEN J. FISHBEIN
DIRECTOR FOR HOUSING AND CREDIT POLICY
CONSUMER FEDERATION OF AMERICA

BEFORE THE

SUBCOMMITTEE ON HOUSING AND COMMUNITY OPPORTUNITY
AND
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

U.S. HOUSE OF REPRESENTATIVES

REGARDING

PROTECTING HOMEOWNERS: PREVENTING ABUSIVE LENDING WHILE PRESERVING ACCESS TO CREDIT

NOVEMBER, 5 2003

WASHINGTON, D.C.

My name is Allen J. Fishbein and I am the Director for Housing and Credit Policy for the Consumer Federation of America (www.consumerfed.org). Chairman Bachus and Ranking Member Sanders, Chairman Ney and Ranking Member Waters, and members of the two subcommittees, we welcome the opportunity to testify today on the important subject of "Protecting Homeowners: Preventing Abusive Lending While Preserving Access to Credit." CFA is a national association of 300 pro-consumer organizations, organized in 1968 to promote consumer interests through education, research, and advocacy.

Predatory lending – exploitative lending to financially unsophisticated borrowers – occurs in all aspects of consumer credit, such as auto finance, credit cards, and short term installment debt. However, the explosive growth of predatory and abusive practices in mortgage lending has deservedly received much attention in recent years. This is understandable. Homeownership is the single most important instrument used by Americans to build wealth. Home equity is the largest component of household wealth representing nearly one-half of the total net worth of the average household. And home equity comprises over 60 percent of the net worth of minority and low-income families. Once households become homeowners, refinanced mortgages become an important financial means for sustaining and increasing household wealth, as they allow homeowners to tap into the equity in their home or to take advantage of falling interest rates to pay for a host of family financial needs.

The positive contributions of the home mortgage refinance market are undermined, however, when homeowners are lured into loans with terms that are not beneficial to them, often as a result of abusive practices by so called "predatory lenders." Predatory lending has been a disturbing part of the growth in the subprime component of the conventional mortgage market, which has grown substantially over the past decade. It has been estimated, for example, that borrowers lose $9.1 billion annually to predatory lending practices.[1] Further, while homeownership nationwide has reached record levels, research indicates that the subprime loan market, and possibly predatory practices, are combining to contribute to record high home foreclosure rates.

My testimony this morning focuses on several points concerning the dangers posed by the emergence of the subprime lending market and why greater emphasis on homebuyer preservation is needed. To summarize these points:

- From Credit Gatekeeper to Credit Peddler -- Subprime lending specialists are subjected to less scrutiny than banks and other depository institutions, making this market a fertile ground for predatory lending practices;

- Subprime borrowers obtain credit through different channels than prime

[1] Eric Stein, Quantifying the Cost of Predatory Lending, Coalition for Responsible Lending, 2001.

borrowers; often entail aggressive marketing to less financially sophisticated borrowers. The resulting dual market that has emerged makes certain borrowers much more vulnerable to being victimized by predatory practices.

- Subprime loans are made disproportionately to low-income and minority households and communities and the absence of mainstream lending in many of these markets means that many borrowers are not receiving cheaper loans for which they qualify;
- Why subprime foreclosures may be the smoking gun of predatory lending; and,
- Legislative and regulatory action is needed to curb the problems associated with predatory lending.

From Credit Gatekeeper to Credit Peddler

Not so long ago, banks, savings, and other depository institutions were viewed by consumers as the gatekeepers of credit. Borrowers assumed that if they did not qualify for a loan their banker would turn them down and if they were seeking a loan too big for them to repay, their banker would provide them with a smaller loan or no loan at all. These days, however, the growth and profitability of subprime lending has led financial institutions to adopt a difference approach. This new approach means that more and more lenders now are willing to lend to almost anyone, and the only the price of credit is at question. This evolution of the markets has worked to expand credit opportunities for some consumers. However, it also has caused some lenders go even further and become quite aggressive in pushing credit onto borrowers. This shift from the traditional role of the lender as "credit gatekeeper" to credit to a new one of as "credit peddler" comes at considerable risk to many consumers.

Much of the new "risked-based" priced mortgage lending occurs through non-bank financial institutions that are not subject to the same types of systematic regulatory oversight as are banks. Unfortunately, consumer protections have not kept pace with this change and are not fully aware of the new "buyer beware" climate in lending. Thus, they may be susceptible to entering into loans that are not right for them, or worse still, being victimized by exploitative and abusive lending practices. The problems associated abusive home equity practices are not new, but the extent of this activity seems to be thriving in the current "no holds barred" lending environment.

A case in point is predatory lending, the subject of today's hearing. Predatory lending practices threatens to reverse much of the progress made in recent years to expand homeownership and the opportunities for wealth building it creates for underserved households. At a time when a record number of Americans own their own home for too many families the proliferation of abusive lending practices has turned the dream of homeownership into a nightmare. Abusive practices in the subprime segment of the mortgage lending market have been stripping borrowers of home equity they may spend a lifetime building and threatens thousands with foreclosure. Further predatory lending disproportionately victimizes vulnerable populations, such as the elderly, women-headed households, and low-income and minority homeowners. The predators selectively and aggressively market their high-cost loans to unsuspecting borrowers, saddling these families with expensive debt, when in many cases they could qualify for less costly loans.

What is predatory mortgage lending?

"Predatory lending" has become a short hand term that is commonly used to cover a range of lending practices that may be disadvantageous to borrowers. A joint Treasury Department/HUD report, Curbing Predatory Home Mortgage Lending (June, 2000), catalogued the key features commonly associated with predatory loans[2]. These include the following:

- Lending without regard to a borrower's ability to repay

Instead of establishing the borrower's ability to pay, predators underwrite the property and charge very high origination and other fees that are not related to the risk posed by the borrower.

- Loan flipping

The predators pressure borrowers into repeated refinancings over short time periods. With each successive refinancing the borrower is asked to pay more high fees, thus stripping further equity.

- Prepayment penalties

Excessive prepayment penalties ensure that the loan cannot be paid off early without paying significant fees, trapping borrowers into high-cost mortgages.

- Balloon payments

Predatory loans may have low monthly payments at first, but the loan is structured so that a large lump sum payment is due within a few years.

- Credit insurance packing

Single premium credit life, disability and unemployment insurance and other fees are "packed" into loans but not disclosed to borrowers in advance. The financing of these products and fees increases the loan balance, stripping equity from the home.

- mandatory arbitration provisions

Mandatory arbitration clauses to resolve disputes are usually required as a condition for

[2] HUD/Treasury, *Curbing Predatory Home Mortgage Lending: A Joint Report*, 2000.

receiving a loan. Such clauses reduce the legal rights and remedies available to victims of predatory lending.

It has been said that while not all subprime lending is predatory, but that predatory lending is almost always related to the subprime market. Part of the explanation for this appears to be the fact that non-bank subprime lending specialists are not subject to a system of supervision comparable to that which is applied to federally and state chartered banks and other financial depository institutions. This lack of supervisory oversight increases the prospects that abuses may occur that go undetected. For the most part the lending practices of subprime specialists are not routinely reviewed by regulators through on-site examinations to ensure they are adhering to appropriate consumer protection requirements. Thus the burden of enforcement for this segment of the mortgage industry essentially falls on individual consumers, who must first know the law, recognize when a violation has occurred, and elect to[3] take appropriate action. At best, this complaint-driven enforcement system works for only the most egregious of lending practices.

The growth of subprime lending and emergence of a dual mortgage market

Subprime lending has grown rapidly as a segment within the conventional home loan market. From 1993-1999, the number of loans reported by subprime specialists increased tenfold from 104,000 subprime refinance loans in 1993 to 1 million in 1000. In 1994, the $35 billion in subprime mortgages represented less than 5 percent of all mortgage originations. By 2002, subprime lending had increased to $213 billion to 8.6 percent of originations in a high volume refinance year (subprime originations in recent years have represented as much as 13 percent of the mortgage market).

Subprime lending can provide expanded opportunities to borrowers that do not meet credit standards in the prime market to buy new homes, to improve their homes, or to access the equity in their homes for other consumer purposes. However, most subprime borrowers use this form of financing for debt consolidation and other consumer credit purposes rather than for housing purposes. When undertaken responsibly, subprime lending can benefit credit impaired borrowers, including those who may have blemishes on their credit record, an insufficient credit history, or nontraditional credit sources. However, the subprime market is comprised of many lenders who operate outside regulatory oversight, and therefore, thus it also can be a fertile ground for predatory lending activities.

The growth of subprime lending has also facilitated the emergence of a dual mortgage delivery system, in which new types of lending institutions provide distinctly different mortgage products to lower income markets than those commonly offered in higher-income markets. Conventional prime rate mortgages typically contain payment terms that are relatively straightforward and without contingent terms or hidden pricing. The prime market loans feature fixed-rate mortgages with interest rates that do no fluctuate, thereby assuring borrowers that they will have the same payments for principal and interest every month for the life of the loan. Although the prime market offers alternatives to fixed rate mortgages, such as adjustable interest rates and balloon payments, these are usually left to borrower discretion. Thus, the borrower's ability to repay is solely dependent upon their future income and not on changes economic and credit conditions, which can affect interest rate movements.

In contrast to the prime market, as anyone who has reviewed subprime loan documents can attest, the payments on subprime loans are less easily understood. These loans contain terms and conditions typically require borrowers to make difficult computations about events outside of their control. These loans often feature adjustment- rate features whose interest rate and, therefore, monthly payments fluctuate. They may also contain additional provisions that strip borrowers' equity, such as prepayment penalties and balloon payments, which make it difficult for the borrowers to determine whether future market conditions will permit them to refinance on affordable terms when the balloon payments come due.

The marketing by subprime lenders is also frequently quite different than the way the mainstream mortgages are marketed. It usually starts with a telephone call, a mailing, or a door-to-door solicitation during which time unscrupulous lenders, brokers, or home improvement contractors attempt to persuade a borrower to use home equity for a loan. High-pressure sales techniques, deception, and outright fraud are often used to help "close a deal." According to an AARP survey, over three-quarters of seniors who own homes receive these solicitations, while many take out loans relying solely on these overtures, without taking the necessary time to shop around to find the best possible loan deal for them.

Also, typically products targeted to low-income or credit impaired borrowers have higher interest rates and less favorable terms that the conventional prime loans provided by mainstream lenders. Over the past decade, Government-backed loans and lending by subprime and manufactured housing specialists account for almost two-thirds of recent increases in lower-income neighborhoods. Conventional prime lending accounted for just 37 percent of the growth in lower-income lending, compared with 81 percent of loan to higher-income borrowers in higher-income neighborhoods.[4]

Income and Racial Disparities in the Subprime Market

A growing body of research has shown that subprime loans are made disproportionately to low-income and minority households and are concentrated in low-income and minority neighborhoods. Although these studies recognize that differences in credit behavior explain some of the disparities in subprime lending across the neighborhoods, they argue that the absence of mainstream lenders has also contributed to the concentration of subprime to these patterns. Because of the much higher incidence of predatory practices within subprime lending market, high concentrations of subprime lending in these markets, as these studies all show, also indicate the likelihood of the greater occurrence of predatory lending practices victimizing borrowers residing in these communities.

[4] Joint Center for Housing Studies of Harvard, *The State of the Nation's Housing*, 2002.

For example, as part of the Treasury-HUD Task Force on Predatory Lending, HUD documented the concentration of subprime lenders in low-income and minority communities in five cities (Atlanta, Los Angeles, Baltimore, New York, and Chicago). The studies found that subprime loans were three times more likely in low-income neighborhoods than in high-income neighborhoods and five times more likely in African American neighborhoods than in White neighborhoods. In fact, HUD found that homeowners in upper-income African American neighborhoods were twice as likely as homeowners in low-income White neighborhoods to have subprime loans.[5]

Another study prepared by Calvin Bradford on subprime lending patterns in all of the nation's 311 metropolitan areas reached similar conclusions and indicated that the magnitude of these disparities raises serious questions about the extent to which risk alone could account for such patterns.[6] The study found that African American borrowers are nearly three times and Latino borrowers nearly two times more likely to receive a subprime loan than their white counterparts. These racial disparities exist in all regions of the nation and in metropolitan areas of all sizes. Bradford's analysis also suggests that racial disparities actually increase as income increases suggesting that a portion of subprime lending is occurring with borrowers whose credit histories would qualify them for low-cost, conventional prime loans.

There is other evidence that risk factors do not explain racial differences in the use of subprime lending. A study by the Research Institute for Housing America concluded, "after controlling for borrower income, debt, and credit history, racial groups behave differently.[7] Specifically, the study noted that minorities are more likely to use subprime lending than whites.

A lack of competition from prime lenders in low-income and minority neighborhoods has increased the chances that borrowers in these communities are paying a high cost for credit. The finding that upper income African American borrowers rely more heavily on the subprime market than low-income White borrowers suggests that a portion of subprime lending is occurring with borrowers whose credit would qualify them for lower cost conventional prime loans. There is also evidence that the higher interest rates charged by subprime lenders cannot be fully explained solely as a function of the additional risks they bear.

Both Fannie Mae and Freddie Mac, the publicly chartered secondary mortgages market enterprises, have suggested that a significant portion of subprime lending is occurring with borrowers whose credit would qualify them for cheaper loans sold to the GSEs. Freddie Mac staff has estimated that 10 to 35 percent of subprime borrowers meet Freddie Mac's purchase guidelines for conventional loans.[8] Fannie Mae has stated that

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[5] HUD report, *Unequal Burden: Income and Racial Disparities in Subprime Lending in America*, 2000.
[6] Calvin Bradford, *Risk or Race? Racial Disparities and the Subprime Refinance Market*. A report prepared for the Center for Community Change, 2002.
[7] Anthony Pennington-Cross, Anthony Yezer, and Joseph Nichols, *Credit Risk and Mortgage Lending: Who Uses Subprime and Why?* Research Institute for Housing America, 2000.
[8] Freddie Mac, *We Open Doors for America's Families, Freddie Mac Annual Housing Activities Report for 1997*, 1998.

half of all mortgage borrowers steered to the high-cost subprime market are in the A-minus category, and therefore are prime candidates for Fannie Mae.[9]

High Foreclosure Rates on Subprime Loans

While there is a variety of evidence that indicating that opportunistic pricing practices and predatory lending practices have been on the rise, unfortunately there is no systematic data available on the volume of loans that might be considered predatory. One consequence of predatory lending is that borrowers are stripped of the equity in their homes, which placed them at an increased risk of foreclosure. In fact, high foreclosure rates for subprime loans – currently one out of every eight subprime loans is either seriously delinquent or in foreclosure – provide the most concrete evidence that many subprime borrowers are entering into mortgage loans they simply cannot afford. A study of default and foreclosure experience of 16 large subprime lenders estimated that the default rates for subprime loans were three times as high as the default rate for all mortgages.

The wave of foreclosures now coming out of the subprime market has been documented by at least ten research studies of subprime foreclosure activity in various local markets. The findings from these studies raise important concerns about the impact of subprime loans on low-income and minority neighborhoods. They also provide the most compelling evidence that subprime lending has become a fertile ground for predatory practices is that current disproportionate percentage of subprime loan foreclosures in low-income and minority neighborhoods.[10]

The higher risk of foreclosure associated with subprime lending reinforces concerns that predatory lending can potentially have devastating effects not just on individual families but also on the neighborhoods where they reside. Because subprime loan are so heavily concentrated in communities of color, this also raises the prospect of concentrated foreclosures that may affect entire neighborhoods, including those homeowners whose loans are in good standing.

Further, the extremely high incidence of subprime foreclosures has also been termed the smoking gun of predatory lending.[11] For example, research suggests that foreclosures of subprime loans have increased rapidly with the growth of subprime loan originations and account for a larger share of overall foreclosures than total loan originations. For example, according to a study of Baltimore foreclosure activity conducted by HUD in 2000, subprime loans accounted for 45 percent of all foreclosure petitions in that city, compared with only 21 of all loan originations. In Atlanta, it was found that overall share of foreclosures attributable to subprime lenders was 16 percent, also larger than the subprime share of originations (9 percent).

[9] Washington Post, *Fannie Mae Vows More Minority Lending*, March 16, 2000, page EO1.
[10] Allen Fishbein and Harold Bunce, *Subprime Market Growth and Predatory Lending*, HUD, 2000.
[11] Harold Bunce, Debbie Gruenstein, Christopher E. Herbert, and Randall M. Scheessele, *Subprime Foreclosures: The Smoking Gun of Predatory Lending?* HUD, 2000.

In addition, the research indicates that foreclosures of subprime loans occur much more quickly than foreclosures on prime loans, and that they are concentrated in low-income and African neighborhoods. The Baltimore study, along with other foreclosure studies conducted for Atlanta and Chicago found subprime lenders foreclosed much more quickly than prime lenders. In Baltimore, for example, the mean lag between the loan origination and the date that the foreclosure petition was filed was only 1.8 years for subprime loans compared with more than 3 years for prime loans. Very similar results were found in Atlanta and Boston. The fact that most of subprime loans reaching foreclosures had a median age of three years, compared to as much as seven years for loans made by prime lenders suggests that the loans were not affordable for the borrowers even at the time of origination and therefore, very possibly were predatory.

Legislative and regulatory action is needed to curb predatory lending

Given the scope and nature of the problems a comprehensive set of solutions is needed to curb predatory lending involving all levels of government, the mortgage and real estate industries, working together with local community, housing, and consumer organizations. This was the approach recommended by the Treasury/HUD National Task Force on Predatory Lending in 2000.

Federal Reserve Board Governor Edward Gramlich in a speech he gave last month cited a number of positive steps that have been taken at the federal, state, and local levels, at least in varying degrees. And indeed Governor Gramlich is right. There has been some movement to address the problem of predatory lending. Unfortunately, it has not been nearly enough.

Some predatory practices are already clearly illegal and can be dealt with through effective enforcement of both federal and state law. However, while perhaps it once was, it should no longer be a "dirty, rotten secret" that predatory lending operates in the grey area of the law. Many of the worst abuses are more subtle and therefore, difficult to address without the enactment of additional consumer protections.

Consequently, new legislative action is needed to provide consumers in the high cost loans market with the protections they need to borrow in the subprime loan market. Some steps the Congress should consider.

1. *Strengthening the Home Ownership and Equity Protection Act (HOEPA)*

HOEPA continues to remain a useful, but far too limited tool. It still covers too few high cost loans. It does not cover home purchase or home equity and home improvement loans that are structured as open-end credit lines. Moreover, the statute does not cover some important abuses associated with high cost lending, nor does it provide for adequate civil remedies to address violations of the statute. Important features that should made to HOEPA include --

- Revising the definition of "High Cost" Mortgage to expand the scope of coverage for subprime borrowers by lowering the triggers for when certain consumer protections are triggered –

a) First mortgages with APRs that exceed Treasury securities by 6 percentage points (current law is 8%)
b) second mortgages with APRs that exceed Treasury securities by 8 percentage points (current law is 10%); or
c) mortgages where total points and fees payable by the borrower exceed the greater of 5% of the total loan amount, or $1,000 (including making the definition of points and fees to be more inclusive).

- Providing additional protections for high cost mortgages under the new trigger definitions.

  a) Restrictions on the financing of points and fees
  b) Limitations on the payment of prepayment penalties
  c) Further prohibitions on balloon payments
  d) Prohibitions on upfront payment or financing of credit life, or comparable products on a single premium basis
  e) Extension of liability for home improvement contract loans
  f) Limitations on mandatory arbitration clauses
  g) Increase statutory damages in individual civil actions and class action

- Assignee liability requirements are critical to ensuring that the secondary market does not support predatory lending practices. Any new provisions adopted by Congress to address predatory lending should include some reasonable degree of liability for assignees.

Legislation along these lines was introduced in the last Congress by Senator Sarbanes and then Rep. John LaFalce.

In an effort to fill gap in consumer protection for subprime borrowers a number of states have enacted their own predatory lending laws. As a rule, these state laws are patterned after HOEPA. The better ones, such as in North Carolina, New Jersey, New Mexico, New York and several other states have sought to cover a larger segment of the subprime market, prohibit or place limits on additional abusive practices, such as the financing of fees, and establish suitable standards for determining "assignee liability" for subsequent purchases and/or investors in loans with predatory features.

State anti-predatory laws can serve a useful function to curbing predatory practices, particularly those not address by federal legislation. They also provide opportunities for experimentation to find the most effective approaches for curbing abusive mortgage lending practices. Moreover, states protections traditionally have formed an important component in a federal system of protections for consumers. Accordingly, the enactment of Federal legislation to strengthen HOEPA should not preclude states from continuing to regulate in this area.

2. *Congress should establish lender liability for illegal broker/contractor acts.*

Most subprime lending is conducted through mortgage broker channels. There is evidence that a very large number of third parties brokers that participate in the origination of predatory loans employed aggressive marketing and solicitation practices. Better regulation of mortgage brokers, therefore, would be helpful in deterring some aspects of predatory lending. Most regulation of mortgage brokers, home improvement contractors, and appraisers occurs at the state level. However, this oversight is uneven, and in some cases non-existent. Making lenders liable for broker or home improvement contractor malfeasance if such party act as the lender's agent would help to improve the accountability and policing of third parties engaged in predatory practices. Encouraging better regulation of these entities at the state and local levels would also help to weed out those third parties engaged in unscrupulous practices.

3. *Encouraging the Expansion of Prime Lending in Underserved Communities*

The lack of competition from prime lenders in low-income and minority neighborhoods increases the chances that borrowers in these geographic areas are paying more for credit than they should. Part of the reason for prime eligible borrowers receiving high cost or predatory loans is that they have been misclassified by large financial conglomerates that do not have adequate systems in place to "refer-up" would be borrowers who walk into a subprime affiliate but whose credit record may qualify them for a prime loan.

Accordingly, Congress should encourage federal banking regulators to use their authority under the Community Reinvestment Act and other laws to "promote" borrowers from the subprime to the prime market, while penalizing the lenders they supervise that engage in predatory lending practices.

This concludes my testimony. Thank you again for the opportunity to testify. I will be happy to answer any questions members of the committee may have

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THE BOND MARKET ASSOCIATION

Statement of Micah S. Green
President, The Bond Market Association

Before the
Subcommittee on Housing and Community Opportunity
Subcommittee on Financial Institutions and Consumer Credit

Hearing on Protecting Homeowners: Preventing Abusive Lending While Preserving Access to Credit
November 5, 2003

I would like to thank Chairman Ney and Chairman Bachus for the opportunity to testify today at this important hearing on predatory lending. I am Micah S. Green, president of The Bond Market Association, which represents approximately 200 securities firms and banks that underwrite, trade, and sell fixed-income securities both domestically and internationally.

The secondary market for mortgage debt—the segment of the financial industry that purchase and repackage loans as mortgage-backed securities or MBS—witnessed tremendous growth over the past decade. At present, there are about $5 trillion in mortgage-related bonds outstanding, or nearly a quarter of all fixed income securities. Such significant participation by the capital markets in the mortgage lending business benefits consumers in the form of lower interest rates and more widely available credit. No doubt there are thousands, if not millions, of families who were able to find mortgage financing and purchase a home because of the secondary market.

This success has come with some setbacks, however, as the volume of subprime loans extended to consumers has ballooned and incidents of predatory lending appear to have increased. There can be no question that such abusive lending practices are bad and should be stopped. In response to this trend, state and local governments have pursued many different anti-predatory lending initiatives. Some of these efforts would place new responsibilities on participants in the secondary market. Some initiatives adopt an approach that could make loan purchasers the subject of lawsuits by borrowers who believe the lender committed lending abuses.

The Bond Market Association opposes the concept of extending liability to the purchaser or assignee of a loan for violations of which they had no knowledge. The Association supports the right of borrowers to defend themselves in the event an assignee seeks to foreclose on their property. But the concept of "assignee liability" embodied in recent anti-predatory lending measures goes a step further. It would grant borrowers the ability to seek redress from the loan purchaser for virtually any alleged violation during the origination process. This is bad public policy that will ultimately shrink the supply of credit available to subprime borrowers. It is important that well-intentioned proposals to combat predatory lending—such as the statutes discussed below—not seek to use the secondary market as an enforcement tool. Moreover, subprime borrowers would benefit from a single national standard as opposed to the present variety of state and local predatory lending laws. Disparate and conflicting rules in multiple jurisdictions will raise the cost of credit as secondary market participants pass on compliance costs or withdraw funding which limits competition among lenders.

Georgia and New York: Examples of the Wrong Approach

With the expansion of the subprime market has come increased scrutiny from regulators and consumer groups concerned with alleged abusive tactics used by some lenders. The practice has no clear-cut definition, but is commonly called predatory lending. Generally, a predatory lender is one who violates consumer lending laws to take financial advantage of a borrower in the course of originating a loan or else uses legal loan features or lending tactics in an abusive way. Examples include loading up loans with points and fees that are disproportionate to the amount an individual is borrowing, as well as outright fraud and misrepresentation. Loans extended without regard to a borrower's ability to repay or with features such as balloon payments that are unfavorable to borrowers can also be considered predatory. Predatory lending is sometimes also associated with home improvement contractors who offer to arrange financing for cash-poor homeowners.

As predatory lending captured headlines in the late 1990s, regulators at the state and local level began to address the issue. One of the first to act was the state of North Carolina with a 1999 statute that defines a high-cost loan more narrowly than the federal HOEPA (Homeowner Equity Protection Act) standard in addition to prohibiting certain practices. Several other states and some cities have passed similar anti-predatory lending laws with varying effects on the secondary market.

Generally, state and local initiatives sought to tighten the definition of a high-cost loan under HOEPA. In Georgia, lawmakers approved the Georgia Fair Lending Act (GFLA) which included an assignee liability provision that would hold secondary market participants responsible for the actions of lenders should they purchase predatory loans. The Georgia law proved so disruptive to the mortgage market—mortgage rates reportedly jumped a quarter of a percentage point as market participants withdrew—the legislature was forced to repeal the assignee liability provisions.

Like other anti-predatory lending legislation, GFLA expanded the definition of covered loan established under HOEPA using sometimes vague criteria. More importantly from the Association's perspective, anyone who purchased a covered loan, or is assigned the loan, would have become liable for the actions of the originator and face unlimited potentially unlimited damages.

THE BOND MARKET ASSOCIATION

Under GFLA, assignees—including loan purchasers and securitization trusts—are subject to claims that borrowers might raise against lenders whether or not the assignees knew of the circumstances giving rise to the alleged violation. The secondary market signaled early on that the Georgia law would disrupt that state's mortgage market when Freddie Mac announced it would no longer purchase loans covered by the law. Several other financial institutions followed suit and at least 40 lenders[1] left the Georgia market because of the law. The legislature has since repealed parts of GFLA and many lenders have returned.

While several lenders and secondary market participants lobbied against GFLA and announced intentions to leave the market early on, the critical blow to the new statute came when the three major credit rating agencies said they would not rate pools of mortgages that included Georgia loans. Without credit ratings, the MBS backed by pools including at least one Georgia loan would be shunned by many traditional investors such as pension funds or endowments that are only permitted to invest in "rated" securities. The secondary market, then, would likely stop purchasing these loans. The rating agencies called for revisions to clarify the circumstances under which assignees could be held liable and a reasonable limit on the damages borrowers could seek. The legislature recognized losing the secondary market as a funding source for the Georgia mortgage market would ultimately hurt Georgia borrowers by raising mortgage rates.

Aside from Georgia, rating agencies have also assessed the effect a law enacted in New York State would have on investors in pools that contained loans covered by the statute. The agencies concluded they would decide whether to rate such pools on a case-by-case basis so long as they only included a minimal amount of "high-cost" loans as defined by a law that became effective April 1, 2003. Even this relatively limited uncertainty will increase the cost of securitizing New York State loans, which in turn will put upward pressure on mortgage rates in that state. Ultimately, disrupting the secondary market for subprime loans will always hurt the subprime borrower in the form of higher interest costs and fewer borrowing opportunities.

If investors cannot be certain of the risk associated with investing in MBS because of the jurisdiction in which one of the loans backing the security was originated, they will demand a higher return. Under such a scenario, MBS will become less attractive as a source of mortgage loan funding. Subprime borrowers will face higher interest rates and less available credit.

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[1] See *Georgia Rattles US Home Equity Market: State legislation to Protect Sub-Prime Borrowers is Threatening a Sector Worth $132 billion last Year*, by Jenny Wiggins, Financial Times, Feb. 13, 2003, p. 21.

Clarifying Assignee Liability

Under current law, civil actions brought against lenders for infractions of HOEPA may also be brought against an assignee of the lender if the violation is "apparent on the face of the loan document."[2] An assignee or the purchaser of a mortgage will not be subject to the claims and defenses of the borrower if a "reasonable person exercising ordinary due diligence, could not determine" the mortgage was a high-cost loan under HOEPA.[3] Unfortunately, neither this standard nor subsequent court decisions have effectively settled the question of what "apparent on the face" means in practice. The recent Georgia and New York State laws compound this problem by creating still more standards for assignee liability.

The presence of loans originated using predatory practices in the pools of loans backing mortgage securities is not in anyone's best interest. Not only do predatory lenders target individuals with risky credit profiles, but the terms of predatory loans often promote default. The more defaults a MBS pool experiences, the less attractive the security becomes to investors. Securitizers of mortgages, then, have a clear incentive to eliminate from pools any loans they can identify that violate applicable predatory lending laws.

Though presently facing a court challenge, a recent New York City law seeks to employ the secondary market as *de facto* policeman by requiring an arbitrary level of due diligence on loan pools in order to escape liability for subprime lending violations. Complying with the due-diligence level set by this statute could significantly raise the cost of purchasing covered mortgages, which would increase borrower costs.

In many cases, such screening would simply be impossible. The bill requires assignees to determine whether subjective loan origination standards were met, such as whether the terms of a loan were misrepresented or whether the loan provides a "net tangible benefit" to the borrower. The purchaser of a loan cannot know what a lender told a borrower. Nor does the purchaser have unique insight into what type of loan or specific loan features are suitable for that borrower. Blanket assignee liability under these circumstances is unreasonable. Assignees have neither the opportunity to identify violations in advance of purchasing the loans, nor the ability to mitigate legal exposure once they do identify violations.

Nonetheless, this approach effectively holds assignees responsible for the conduct of lenders by threatening to void the assignee's interest in the loans they have purchased unless the arbitrary due-diligence level is met.

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[2] 15 U.S.C. 1641(a)

[3] 15 U.S.C. 1641(d) 1

Preemption: The Need for a National Standard

Several other states and localities are pursuing—or have enacted—legislation similar to the new Georgia and New York laws. Not only are these initiatives unduly restrictive, but their substantive provisions are frequently inconsistent from one jurisdiction to another. This fragmented approach to legislating the parameters of "acceptable" and "unacceptable" subprime lending threatens to balkanize the subprime credit industry in the United States. The outcome might well be a return to the days of severely limited credit opportunity and significant regional and local disparities in credit availability for those who need credit most.

The development also presents a new compliance burden for lenders and secondary market participants. Multi-state lenders must constantly adjust lending practices and underwriting standards as new statutes with varying definitions of predatory lending emerge in different states. In some instances—Georgia, for example—lenders will choose to withdraw completely from the market for certain loans. In other cases, lenders may choose to adjust underwriting guidelines to minimize the chance of violating new standards. In doing so, subprime lenders run the risk of violating the federal Fair Lending Act, which prohibits the denial of credit under certain circumstances. This type of regulatory confusion only creates a disincentive for lenders to participate in the subprime market at all. The preservation of credit for borrowers in all markets is one of the strongest arguments available in favor of federal preemption of state and local predatory lending laws.

The Need for a National Standard for Assignee Liability

The Association believes clarifying the potential liability to which a secondary market participant can be exposed and making that standard applicable nationally, is the best way to stop predatory lending without disrupting the secondary market for subprime loans. Such an approach would strike a better balance between consumer protection and market forces than any state or local initiative enacted or introduced to date. We urge these committees to consider the need for preemptive legislation in order to ensure subprime borrowers enjoy continued access to credit that is reasonably priced and widely available.

Broad assignee liability provisions are not necessary to ensure that borrowers have remedies available to them in the event of a foreclosure on their home. Regardless of whether the original lender or an assignee holds a loan, if the loan was made on predatory terms, borrowers should have the right to make such a claim.

There can be no doubt predatory lending is a harmful practice with which no reputable part of the American financial industry wants to be associated. Threatening secondary market participants with assignee liability to enlist them as enforcers of acceptable lending practices, however, makes their participation in the market for subprime residential mortgage market largely untenable from an economic perspective.

Withdrawing the liquidity provided by the secondary market will deny credit to thousands of subprime borrowers. The access tens of thousands of deserving borrowers once had to mortgage credit would be lost.

Placing the burden of enforcement of anti-predatory lending rules on the secondary market is bad public policy with consequences that are both undesirable and unnecessary.

Thank you again for the opportunity to testify on this important issue today.

Testimony of

THOMAS J. MILLER
ATTORNEY GENERAL, STATE OF IOWA

"Protecting Homeowners: Preventing Abusive Lending While Preserving Access to Credit"

Before the
Subcommittee on Financial Institutions and Consumer Credit and the
Subcommittee on Housing and Community Opportunity
United States House of Representatives

November 5, 2003

Thank you for inviting me to share some of the lessons I have taken from our experience with enforcement in the subprime mortgage lending arena. This is a subject of vital economic and emotional importance to millions of families, and, in the long run, to the American economy. I hope this hearing will help us shed more light than heat on the problem and the full range of solutions which should be considered, for there has been a great deal of the latter in the debates about reform of this industry. These good citizens deserve to have the policies determined based on what the real world looks like, not what theoretical constructs would hope the world looks like.

"ACCESS TO WHAT?" IS THE REAL QUESTION

The title of this hearing suggests two threshold questions. The first question is whether there really must be a trade-off between reform and access. The past 35 years have encompassed much of the consumer protection reform movement – from Truth in Lending in 1969, through the Equal Credit Opportunity Act, the FTC Credit Practices and anti-holder rules, to HOEPA in 1994. Many, if not all of these reforms, when proposed were met with predictions that the sky would fall, and that the unintended consequence would be to "dry up credit" for those the proponents of reform were trying to protect. A look at the sheer explosion of consumer credit in those decades demonstrates that such fears were ill-founded.

The more fundamental threshold question is whether there really is a possibility that efforts to curb home equity depletion for a great many Americans would restrict access to appropriate credit? That is a different question than whether it would restrict access to credit. The distinction is critical, and responsible policy makers must keep it constantly in mind. Reducing access to the kind of credit that steals equity – the primary (or only) source of wealth for many Americans – is the goal of effective anti-predatory lending laws. It is an easy sound bite to reduce the debate to "regulation will limit access," but behind that slogan is an assumption that "more is better." When the product is debt, and the cost is equity depletion, record foreclosures and bankruptcies from inappropriate credit, and declining neighborhoods, we must be leery of making such a facile assumption.

There are many things in life where more is not necessarily better. Antibiotics have given us great strides in improving longevity. But with antibiotics, more is not better: too much use and indiscriminate use has negative effects both on the individual, (building up immunity), and on the community as a whole (with the growth of resistant strains). Like most public policy questions, it is not as simple a question as it is made to sound, and it is imperative that the policy makers not act (or fail to act) on oversimplifications. The potential consequences are far too great. Household debt today is at record levels, and homes stand behind most of that debt. The indicators are not of too little access to useful and manageable credit. Instead we see signs of too much access to problem credit. By one estimate, subprime lenders, the arena in which most of problem lending occurs, account for 10% of the mortgage lending market, but 60% of the foreclosures.[1] Reducing access to devastating debt should be a goal: it cannot be assumed that

[1] The Mortgage Bankers Association reports in its National Delinquency Survey for the third quarter of 2002 that
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all reduction in access to subprime lending is an undesirable outcome. Quite the contrary. Successful regulation will reduce access to predatory lending. That is why thoughtful, careful analysis of the North Carolina experience such as the UNC study is so important.[2] It shows a reduction in access to predatory lending – but no reduction in access to appropriate lending, nor rise in the price of credit. In short, the North Carolina legislation is doing what it was intended to do.

I would also like to make a brief comment about securitization and holder liability, which the next panel will focus on in more detail. Enforcement to curb unfair and deceptive practices by lenders who rely on securitization to fund and transfer their loans faces serious practical and legal obstacles. Lenders who securitize their loans, then file bankruptcy, make very difficult enforcement targets. The assignees of the loans in the secondary market are trusts and investors who protest that they can't change a retail lender's practices, and it would be unfair to force them to make restitution to consumer victims. This is not uncharted territory, and the lessons from experience are that this is manageable.

Ten years ago, when Congress first examined the predatory mortgage problem, it well understood that the secondary market was part of the problem – that's why HOEPA restricted the ability of assignees to raise the holder in due course defense to borrowers' claims and defenses

8.58% of subprime mortgages are in foreclosure, compared with 1.15% for all mortgages. The National Mortgage News Quarterly Data Report for the fourth quarter of 2002 reveals that there were $574 billion in subprime mortgage loans outstanding, or about 5.5 million mortgages, and 9% of the total outstanding residential mortgage debt reported by the Federal Reserve Board (about $6.3 trillion). There would therefore be about 470,000 subprime mortgages in foreclosure compared with roughly 250,000 prime conventional, FHA and VA mortgages, or 66% of all foreclosures. The MBA notes that its subprime foreclosure rate is based on a small sample of subprime lenders that may not be representative of the market as a whole. Using lower foreclosure rates of 5% to 6% would reduce the subprime share of foreclosures to about 55% of all foreclosures.

[2] Roberto G. Quercia, Michael A. Stegman & Walter R. Davis, "The Impact of North Carolina's Anti-Predatory Lending Law: A Descriptive Assessment," Center for Community Capitalism, University of North Carolina at Chapel Hill. http://www.kenan-flagler.unc.edu/assets/documents/CC_NC_Anti_Predatory_Law_Impact.pdf [Hereafter Quercia, et al.]

about the loan.[3] Though some feared then that it would restrict access, the huge growth in the volume of subprime lending -- including securitizations -- demonstrates that the assignee liability did not reduce access.[4] To the best of my knowledge, "innocent" assignees have not faced large damage awards, though some players in the secondary market have had to accept the consequences of their own conduct. The recent award against Lehman Brothers, for example, was assessed by the jury for Lehman's own conduct in aiding and abetting First Alliance Mortgage Company's (FAMCO) fraud on borrowers, with the jury carefully apportioning responsibility.

The assignee liability provisions of HOEPA were based in part upon a prior successful effort to assure that liability for conduct relating to credit paper followed that paper. The FTC anti-holder rule made assignees or related lenders liable for the claims and defenses which the buyer would have against the seller. That has not dried up home improvement credit, but has been invaluable in both public and private enforcement by making the buyer's claims and defenses travel with the note and mortgage, rather than making them disappear with a shady contractor.

PROBLEM PRACTICES IN THE SUBPRIME MARKET

One of the early myths about "predatory lending" was that only marginal players in the market engage in problem lending. Our multistate investigation of Household and the FTC action against Associates (which was acquired by Citigroup in 2000 and merged into its subsidiary CitiFinancial) indicate otherwise. CitiFinancial and Household were the top two subprime lenders in 2002, with over 18.5% of the subprime market share between them

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[3] 15 U.S.C. § 1641(d). See, e.g. *Problems in Community Development Banking, Mortgage Lending Discrimination, Reverse Redlining, and Home Equity Lending,* Hearings Before the Senate Comm. On Banking, Housing and Urban Affairs, 103d Cong. 1st Sess. (Feb. 17, 1993) [testimony of National Consumer Law Center.]

[4] Securitized subprime loans increased over seven-fold between 1994 and 1999. See Quercia, et al, note 2, supra, at p. 2. (HOEPA became effective October, 1995).

according to industry figures.[5] The nature of the alleged practices in both these cases demonstrate how the subprime market operates in many crucial respects contrary to the theoretical "self-correcting" marketplace.

Before proceeding to discuss some of the practices at issue and the reforms embedded in the settlement's injunction, I want to thank Household for its cooperation during the states' investigation. The company took responsibility. In doing so, sometime next month $484 million will be returned to its borrowers — a record amount. More importantly, we belive the injunctive relief in our consent judgment represents significant reforms. The commitment and the massive effort that Household is putting into implementing these reforms is commendable. I look forward to working with them as the implementation process continues.

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[5] *Inside B & C Lending*, p. 2 (February 3, 2003).

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There were approximately thirteen challenged practices in the investigation of Household by state financial regulators and attorney generals.[6] Among them were excessive fees and points, typically 7% or more of the loan, high prepayment penalties and misrepresentations concerning them, misleading sales pitches designed to conceal real interest rates and the high points, insurance-packing, "loan-splitting," and making refinance loans with no real net benefit to the consumer. Many of the these problems in marketing and sales practices in Household were similar to the allegations against Associates by the FTC.[7] These cases illustrate some of the fundamental characteristics of the subprime marketplace that we all must keep in clear focus.

Access to the Products Offered Vs. The Products Needed

Alan Greenspan recently spoke of the $700 billion in equity Americans "extracted" from their homes. For you and me and many others in this room, that "extraction" reflected refinances to lower-rate mortgages, which freed up disposable income for us. Refinancing in the subprime market extracts equity, but often does not free up disposable income. Instead, it sometimes turns prime mortgage debt into more costly subprime debt, or simply churns high-cost debt into more high-cost debt.[8] That extracts equity. Churning debt is not a productive use for mortgage debt, any more than churning is productive for the consumer in the sale of securities or insurance. Yet refinancing is the major component in the phenomenal growth of subprime lending, constituting 65% of subprime loans in 2000.[9] A recent AARP study confirms what

[6] These are briefly described in the states' complaints. Typical of those complaints is State of Iowa v. Household, International, Petition, Para. 8(A) - (M), a copy of which is attached as Appendix C to this testimony.

[7] Federal Trade Commission v. Citigroup Inc., et al, (N.D. Ga., No. 1:01 - CV - 0606 JTC, complaint filed March, 2001)

[8] A study of subprime lending in Philadelphia suggests that the rate of refinancing prime to subprime loans and subprime to subprime loans is higher in what it terms "high potential vulnerability neighborhoods." It defines these neighborhoods to be ones with lower housing values, a high percentage of older homeowners and a high percentage of homes owned free and clear. "Predatory Lending: An Approach to Identify and Understand Predatory Lending," a report from the Reinvestment Fund (TRF).(www.http://www.trfund.com/policy/FordForWeb.pdf)

[9] Older Subprime Refinance Mortgage Borrowers," AARP Data Digest # 74 (July, 2002)

we've known about many of these loans being "sold, not bought," – driven by supply, not demand. Sixty-one percent (61%) of older subprime borrowers reported that the contact was initiated by a broker or lender, not by the consumer. (Only 31% of older prime borrowers reported the same experience.)[10] Many of these refinances or debt consolidation loans provide no real benefit to the consumers, and may leave them worse off. Two of my constituents presents a good example of costly refinances with no net benefits. This couple had $71,600 in a first and second mortgage on their property when they sought $8000 additional funds from Associates in November, 2000. Five loans and five months later, the encumbrance on their home was $112,250, far more than the home was worth. Their installment debt was some $300 a month higher than it would have been if they'd just been given the loan they sought.[11]

The loan products needed in low and moderate income communities are affordable loans to buy affordable homes – purchase money loans. But that is not a significant portion of the subprime market. The loan products needed by elder homeowners, and homeowners in low and moderate income communities are affordable, non-price gouging home repair loans for quality repairs from reputable home improvement contractors. There is no evidence whatsoever that protections such as the North Carolina law reduce access to those kinds of productive credit – in fact, there is some suggestion that good laws may "crowd out" the destructive debt, making

[10] Id.

[11] That series of transactions included a "minnow" loan (called "Home Owners Express" by Associates) – a small unsecured loan for $8000 at 24%, payable in 6 months @ $1432 / month. That "Home Owners Express" loan is used as a kind of "bait and switch" for mortgage loan applicants and serves to undermine the Truth in Lending 3-day cooling off right for home equity loans. (See 15 U.S.C. §1635). Two days later, if these customers had balked at signing two loans (a first mortgage refinance @ 17.5% and a second @ 21%), or tried to rescind it, they'd be told they'd still have to pay that $8000 at 24% in unaffordable installments. There were $7000 credit insurance premiums charged in those two mortgages, and the payments were over $300 than they would have been without a forced first lien refinance and insurance packing. Realizing that Associates had pushed too far, Citifinancial rewrote the Associates 1st and 2nd loans just 4 months later, lowering the rates to a still high 15%, but adding $10,600 in credit insurance premiums in the process. That helpful refi took the outstanding encumbrance on the home from $104,240 (a 140% combined LTV) to $112,251 (a 152% CLTV.)

more room for productive credit.[12] In other words, some decline in levels of subprime originations may simply show that the effect of good anti-predatory lending laws is to repeal Gresham's Law. There is no evidence they restrict access to credit -- they may be just what is need to let good money start to drive out the bad.

Spending Wealth – Equity Depletion

Refinancing from prime loans to more costly subprime loans, or churning subprime debt not only does not free up disposable income, it depletes the only stored wealth that many people have – their homes. High interest rates, high fees, and prepayment penalties compound the rate of equity depletion with these loans. The more frequently these loans are written – through churning and flipping – the more is extracted. Attached to this testimony (in Appendix A) are charts which show how the self-inflating nature of some of these fees (particularly points and single-premium credit insurance) can make the same $30,000 in proceeds on a 15% mortgage (a small size loan in the mortgage world) cost an extra $12,000 over the life of a loan, and make the monthly payment rise. Table B of that appendix shows how, in a world of frequent refinancing, that cost is magnified for the consumer over a truncated term. When looking at those figures, keep in mind that they do not reflect any prepayment penalties, which depletes the equity by more thousands of dollars just to try to get out of a loan.

The rising level of equity depletion is running head-on into competitive pressures for growth among subprime lenders, leading to one of the more insidious practices of concern to me in this market, the rise of high loan-to-value mortgages.

High Loan-to-value Loans & Prepayment Penalties: Homeowners Trapped under Water

* Loan splitting and high LTV loans

Mortgage lending has been a high growth area. Too much growth, arguably, so that the

[12] Quercia, et al, supra note 2, at p. 17.

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mortgage market is rapidly becoming saturated. Here, too, the fallacy of automatically applying prime market theory to subprime practices is amply demonstrated. When you and I refinanced our 7% mortgages to 5%, many of us were able then to switch from 30 year mortgages to 15 year mortgages, and build up equity faster. But with the equity-depleting characteristics of high cost mortgages, the effect of refinancing is the opposite. (See note 11.) Consequently, that market becomes saturated faster, and the amount of equity available to tap falls. Yet there remains a hyper-competitive supply market, with pressures to continue to show "growth."[13] In normal businesses, saturation means the suppliers let inventory levels reduce until natural demand resumes. In this respect, too, a reduction in levels of origination of subprime loan would actually be a positive sign of a natural adjustment. But in the long-term mortgage debt business, that hasn't happened. Instead, now that homes are mortgaged to the roof, the air over those roofs is being mortgaged as well.

In the late 90s, a few subprime lenders offering 125% - 135% high loan-to-value mortgage loans aggressively marketed their wares. Many people even in the subprime lending field thought that "the market had taken care of that product," and the hype disappeared. While the hype may have disappeared, the product hasn't – it simply became more subtle and more insidious. And it hasn't disappeared because the goal of growth in supply side runs head on into the reality of approaching saturation.

Household was not the only lender to offer the so-called "piggy-back" loans, though the sales practices alleged to accompany these loans were among the first to come to our attention through complaints. It was a feature of the Associates case, and Conseco did it, as well. The piggy-back loans differ from the original high-LTV product offered in the 90s by offering what the consumer would think of as a single loan, but split into two separate loans made

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[13] *Inside B & C Lending* reported Household loans up from $15.27 billion in 2000 to $20 billion in 2002, while Citifinancial's went from $18.8 billion in 2000 to $19.6 billion in 2002. (*Inside B & C Lending*, March 19, 2001 and February 3, 2003.)

contemporaneously or nearly so. A first lien loan – typically at rates of 12% or more – mortgages from 85 - 100% of the value of the home. A piggy-back second lien loan – at rates we've seen from 16% to 24% – takes the combined loans up to as much as 125% CLTV. (If the appraiser has been generous, as is increasingly happening, the real LTV could be much higher.)

The lenders' rationale behind the higher rate on the piggy-back second is that it is effectively unsecured. But for the borrowers, the homes are at still at risk -- greater risk, in fact.[14]

At first blush, it may be easy to think that people wanted this extra money, and it was still cheaper than borrowing it at unsecured rates. (Though at 20% or more, that is not easy to say with a straight face.) But when one couples the product with the "upselling" of loan amounts,[15] with sales practices which leave many borrowers unaware that there even are two loans until well after the fact, that justification crumbles.

With high-fee loans, the loan-splitting sometimes is even more egregious, for it can be the very existence of the high fees which creates the "need" for the piggy-back second. For example, assume a home is worth $100,000, and has a $90,000 first lien. The borrower was seeking credit for a $6000 roof repair. A 2-point prime loan would make that just under a $98,000 loan. But a loan with 7.5 points plus $2000 in credit insurance and other fees, takes the loan "principal" to $105,350. Since money is fungible, in effect, the piggy-back second of

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[14] For example, these loans are also often unaffordable, or only barely so. In the event of job loss or health expenses, a foreclosure may threaten. In normal circumstances, a consumer could try to sell the home privately at a fair market value, pay the foreclosing lender, and still recoup some equity to move or start over. That is not possible in these circumstances.

[15] "Upselling" is urging more debt than the borrower sought. It happens when a borrower who seeks a $6000 home repair loan is upsold to a $47,000 cash-out refinance; it happens when a straight refinance loan is turned into a debt consolidation loan. It happens when the loan broker or retail loan officer calls back and says "Your appraisal came back higher than we thought. We can give you some extra cash. Think you could use that for a little fix-up around the house?" (Unfortunately, that appraisal is often inflated -- a fact which can come back to haunt the borrower -- and perhaps the lender -- later on.) And while the pitch is often that it is cheaper to roll credit card debt into a mortgage, that loses a lot of its persuasiveness when the mortgage turns into a piggy-back pair at 12% and 20% or higher.

$5350 at 20% or more is simply financing the costs on the primary loan.

Under the terms of our settlement, any piggy-back loans will be unsecured, and we believe that lenders, borrowers, their families, communities -- and the economy as a whole -- would be very well served by the reduction in access to these insidious, extradinarily high-cost piggy-back second mortgages.

* Prepayment penalties.

These high LTV loans, along with perversely prevalent presence of prepayment penalties in the subprime market, keep the customer in these loans. Prepayment penalties formulae are complicated and almost totally opaque. Only the most sophisticated and math-savvy borrower could anticipate the actual dollar amount of a prepayment penalty.[16] Such lack of transparency brings us to a fundamental problem in this marketplace. Martin Eakes has characterized predatory lending as largely a problem of "misplaced trust." With extraordinarily complex transactions or products, with a startling lack of price transparency, even many educated borrowers have to rely upon the good faith and honesty of the "expert" they are dealing with on the phone or across the table. American business does not want to get to the point where every transaction must be an exercise in self-defense for the consumer. And it particularly does not want to get a reputation whereby that is especially the case for elder or unsophisticated consumers. Yet one of the things we heard over and over again was that specific questions about prepayment penalties were met with a breezy answer that that would not be a problem. Well, not if you don't mind adding as much as $9000 in some cases to pay off your loan early or refinance to a lower rate.

One of the rationales offered for prepayment penalties is that they are a "trade-off" for a

[16] The language from one home equity line of credit addresses the prepayment penalty below the middle of page 3 of a 5 page agreement. It says that if you prepay within five years, you agree to pay a prepayment penalty equal to six months interest, "determined by applying the monthly periodic rate in effect as of the pay off date on the credit limit as shown on page one." That APR equivalent of that periodic rate was 20.15%.

lower rate upfront. In our experience, that is an after-the-fact rationalization that rarely, if ever, has panned out in the subprime market. We have not seen evidence of any such trade-off. Even if there were a trade-off, the lack of information about the price of the prepayment penalty or the value of the rate reduction it purports to purchase precludes an informed choice. If consumers don't know what the cost of that prepayment penalty is, how are they to make an intelligent choice as to whether any rate trade-off is worth the price? If it's a choice at all, it's a black-box choice.

There is no law – not RESPA, not TIL – that helps consumers know in advance what it might cost them to prepay.[17] One of the reforms of the Household settlement is to bring transparency to the prepayment penalty clause. A disclosure must be given of the maximum prepayment penalty which could be imposed in a dollar amount. (Consent judgment, Para. 15(4)). Further, if a rate trade-off is available, the rate differential is to be disclosed early in the application process. (Consent judgement, Para. 15(1, 2).) Finally, the term during which a prepayment penalty may be charged is limited to the lesser of 24 months or as allowed by state law.[18]

* "The Bridge is Out: Detour Ahead."

High LTV loans and prepayment penalties are effective anti-competitive tactics, as well. While those of us in the prime market had lenders competing to get our business as we searched for lower rates in a declining interest rate environment, these underwater (if not drowning) homeowners are trapped in high-cost high LTV loans by the fact that the cycle of equity-stripping loans has been completed for them -- there is no equity left. The prepayment penalty

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[17] TIL simply requires that a box be checked that says "You may have to pay a prepayment penalty." Reg. Z, § 226.18(k). Whether that would be $50 or $5000, the consumer would have to ask. And if they don't get a straight answer, as note 15 indicates, it is not easy to "trust, but verify."

[18] The deletion of prepayment penalty laws from the list of state laws preempted by AMTPA will be of great help in states like mine which limit prepayment penalties.

is a further tax that is not imposed on prime market borrowers seeking lower rates. "On the street" level lingo in the industry demonstrates that the trap is not unintentional. "Closing the back door," "building a fence around the customer," or "taking the customer out of the market" are phrases we've heard to describe lending practices designed to keep customers trapped in these high-cost loans.

These tactics are particularly disingenuous given the fact that many subprime loans are made with the representation that, while they cost more than market rate, they serve as a "bridge" to enable customers with no credit history or blemished history get into the prime market. (This is also one of the benefits often touted for the industry as a whole.) But there can be no bridge when the gate is down at the other end.

Shopping for Credit: the Myth of Self-defense

Shopping for mortgage credit in the subprime market differs greatly from the prime market. "Market" rates in the latter are widely publicized and widely quoted by originators. In contrast, there is virtually no price transparency in the subprime market. Rates and prices are rarely a feature of subprime advertising, and all too often in the subprime market, the game is more one of hide-and-seek, even for those who do ask. But many don't. One recent study shed light on why many borrowers may not do extensive shopping in the first place, with 39% believing that lenders were required by law to give them the best rate.[19] Thinking the law protects them from price-gouging or "opportunistic pricing," they mistakenly trust that there is no need for self-defensive shopping. But, as with the prepayment penalties discussed above, for shopping to work, it has to be met with honesty. Trying to double check the veracity of the sales pitch against the actual documents is no answer. First, the papers with the real numbers come too late in the process. The deal has been closed in all but the technical sense by the time the

[19] "The Growing Demand for Housing," 2002 Fannie Mae National Housing Survey, p. 9. (The figure was higher for minorities.) (http://www.glensold.com/fnmasurvey2002.pdf)

final deal comes out. Second, the pieces of paper with the useful information are buried in a blinding blizzard if legal jargon with no meaning to the lay person. (And it should be noted that the two documents with the most readable and useful information are the two mandated by federal law – the Truth in Lending disclosure and the HUD-1. It is not federal law that is creating the information overload.) Third, the level of both language and quantitative skills demanded of mortgage borrowers is far beyond the performance level of most people, according to literacy studies.[20]

The FAMCO, Household and Associates cases all involved allegations of tactics or omissions used to systematically deceive consumers about the price of credit. First Alliance turned Truth in Lending on its head by confusing sales techniques used to make up to 20 points disappear from the consumers' eyes. Household was alleged to fail to give meaningful RESPA good faith estimates of closing costs, though typically charging over 7 points, and to make deceptive representations about the interest rates. (Credit insurance premiums often are omitted from good faith estimates, as well.) Associates' packing and flipping made any disclosures virtually meaningless.

We'd like to think that numbers can't lie, but they can. I referred earlier to the wide range of equity that can be extracted from a "$30,000, 15%" loan. (Appendix A, Table A) But there are many tricks numbers can play. When a loan officer says he can give you a loan that pays out like a 7.68% loan, that sounds reasonable. If he says, "your papers will say 12%, but it's really an effective rate of 7.68%," you might be skeptical. But he has a fancy calculator, and he punches in the numbers, and indeed, it comes out 7.68%. So even if your current loan is 10%, should still come out ahead, right? Not quite.

If you're a lender and your 12% - 14% rates don't look competitive in a falling rate

[20] See Alan M. White and Cathy Lesser Mansfield, *Literacy and Contract,* 13 Stanford Law & Policy Review 233 (2002).

environment, you can either lower the rates, or lower the quotes. If you choose the latter, you might have to back it up with smoke and mirrors. For example, the way to get from a 12% loan to a "7.68% effective rate" is to sell a bi-weekly payment plan. Any reduction in savings comes from making an extra payment over the course of the year (which you could do on your 10% loan and still come out ahead. Also, you can usually make an extra payment plan without it costing extra, which the bi-weekly plan did.)

Similarly the self-inflating nature of the financed points and charges, as reflected in Appendices A and B is not something that even careful shopping would reveal. But when even the straight upfront dollar amounts of the closing costs are hidden until the last minute, the concept of shopping is illusory. RESPA's good faith estimates (GFE) of closing costs are required to be sent within 3 days of receipt of an application. A GFE showing 7 points ($7000) on a $100,000 loan application could be enough sticker shock early in the process to give a customer pause. But a GFE that discloses a range of, for example $0 -- $7000 is meaningless. That was another issue in the Household case. The rationale in this case spills out onto another myth about pricing in the subprime market. Points can be characterized as "origination points" or "discount points." In theory, a discount point "buys down" the note rate. But again, the lack of price transparency on the interest rates means there's no way to know whether the discount points buy down a rate. And in fact, there is often no evidence that it does. (It's akin to a scam in the auto sale arena, where the price of the purchased car is raised to offset a down payment, or a generous trade-in allowance. It's called "swallowing the down," or "swallowing the trade.") Unless a consumer knows what the rate would be without a discount point – honestly – there is no way to know whether the discount points purchase anything at all, or, if so, how the price paid compares to the value received.

Under the terms of the settlement, the good faith estimate must reflect the likely costs. For three years, Household will limit origination or discount points to 5% of the loan. If discount points are offered, they must be bona fide, and the consumer must be told the price of the buy-down. (Consent Judgment, Para. 6 - 8.)

In selling loans as refinance loans or debt consolidation loans, comparing the prospective borrowers' present situation to the loan proposal, there can be a lot of apples being compared to a lot of kumquats. Constructing sales pitches which purport to blend existing mortgage debt and credit card debt into a single rate for comparison purposes can be misleading, as can comparisons of payments. Existing mortgage payments might include principal, interest, taxes and insurance (PITI), as most prime market loans do. But, unbeknownst to the customer, a proposed subprime loan may not escrow taxes and insurance (and most subprime loans do not.) Further, payment comparisons may be used based on a new loan amount which leaves out charges which almost certainly will be included in the loan. Assuring that debt burden comparisons are apples to apples is another feature of the Household settlement.

Spurious Open-end Credit and Balloon Payments

A number of our offices have long been concerned with the problem of "spurious open-end credit" – credit which for all practical purposes is closed-end credit, but disguised as open-end credit. Consumers do not get the information they need up front, before consummation, about the cost of credit – or even what the monthly payment burden will be with open-end credit. In a genuinely open-end context, this is understandable, because the debt amounts happen after the fact, and they fluctuate day to day. In spurious open-end, the amount of the loan is, for all practical purposes, fixed up front, with the initial disbursal filling the credit line (or exceeding it), and a payment schedule driven by that initial advance. In these circumstances, a reasonable estimate of payment information could be calculated and given up front. But particularly with high priced loans, like some of the piggy-back second mortgages were, accurate before-the-fact information could lead to sticker shock and market resistance. With high-cost mortgage loans, there is an added advantage to the use of spurious open-end credit. Congress excluded open-end mortgages from the scope of HOEPA. That is why many of the piggy-back seconds, typically constructed as open-end, could carry rates as high as 20% - 24%, and not appear on the face of the documents to fall under HOEPA.[21]

These loans were all balloon loans. At those rates, to keep payments low, the loans would not amortize, and there would be a balloon. But there is no payment schedule information required for "open-end" loans, so the existence of a balloon payment on these loans would be a surprise. In the Household settlement, rather than argue about the dividing line between open- and closed-end credit (which in the past has stalled reform efforts on this issue), the settlement gives the consumers the specific payment information before they sign, not years later. (See Consent Judgment, Appx. A in Iowa's, Appx. B in many other states')

_____ *Perverse Incentives*

One of the fundamental tensions in the subprime market is the correlation between increased costs and/or debt load for the borrower and increased compensation for the originator. The "reverse competition factor" creates a tension between the originator's best interests (higher loan amounts and loan costs) and the borrower's best interests (lower loan amounts and loan costs). One of the innovations of the Household settlement is the use of independent loan closers. The loans will be closed by people whose compensation is not dependent upon the terms of the loan or, for Household employees, loan volume. Furthermore, those closers will not report to sales management. We hope this provides a circuit breaker on any incentive for deception in sales.

"Best Rate Available"

______Related to reforms which seek to eliminate the incentive for the sales force to engage in opportunistic pricing is a provision in the settlement by which Household will provide applicants

[21] An amendment to HOEPA regs in 2001 specifically makes it an unfair and deceptive practice to structure a loan as open-end to evade HOEPA requirements. Reg. Z, § 226.34(d).

with the lower rate applicable to one of their products for which the borrower qualifies. As you know, there is evidence that the high-cost market has a sizeable number of borrowers whose credit risk would make them eligible for the prime market. As I mentioned above, almost 40% of respondents of one survey (and a higher percentage of minority borrowers) believe that lenders are required to give them the best rate for which they qualify.[22] We are happy that under the settlement agreement, that particular myth will move closer to reality.

CONCLUSION

The Household and Associates actions addressed a wide array of alleged practices – from sales to servicing. A copy of the Household petition is attached for your reference. The consent judgment is available on our website, and that of many other state Attorneys General and financial regulators. (www.IowaAttorneyGeneral.org) Some of these reforms are present in some form in some of the state laws (such as North Carolina's), and some give shape to the concept of fair and non-deceptive practices. We believe that reform, and greater protections, are not only possible, but in the long run, will lessen the likelihood of negative consequences on homeowners, lenders, communities and the economy as a whole of over-indebtedness and overpriced indebtedness. That isn't restricting access to credit – that's just good business, and that's good for business and good for all of us.

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[22] See note 19, above.

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ENDNOTES

SUBPRIME ALCHEMY

APPENDIX A:
SELF-INFLATING CHARGES:
POINTS AND SINGLE PREMIUM CREDIT INSURANCE

Loan purpose: **refinance a $30,000 debt.**
Note Interest rate: **15%**
Term: **15 years (180 months)**

1. **No frills**: (See Table A, column #1)

Principal:	$30,000.00	*Itemization:*	*$30,000 pay off old debt*
Interest:	$45,578.40		
Total of payments:	$75,578.40		

Mo. Pmt: $ 419.88[i]

1. **Add single premium credit life**: (See Table A, column #2)

a. Single premium credit life charge is typically financed as part of the loan principal.

a. Gross coverage credit insurance pays to insure everything – including unearned interest and the insurance premiums themselves.

a. Where the legally permissible rate is cast as $*x per $100 per year,* the formula for determining the maximum legal premium is:

legal max. rate *x* years insurance is in force *x* total of payments/insured indebtedness[ii] If the lender wishes to increase the premium when the loan is so large that the total of payments hits the maximum, it can increase the years of coverage. (Or, it can add other types of insurance coverage, such as disability or involuntary unemployment. For simplicity's sake, the illustrations in these appendices include only credit life.)
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a. For purposes of illustration, this sample assumes that the legal maximum rate for single decreasing credit life set by the state insurance department is 47 cents per $100 per year.[iii]

a. It also assumes truncated coverage for 5 years.

a. A straight-forward application of that formula to the "no frills" contract would come up with a premium of $ 1776.09, if the consumer were to pay it in cash at closing.

$$\frac{.47 \ x\ 5\ x\ \$75{,}578.40}{100}$$

a. However, since in practice these premiums are financed, either the consumer would get

$1776.09 less than sought, or the premium charge has to be added to the basic loan amount, raising the principal above the initial $30,000 sought. Since the purpose of this loan is to refinance a $30,000 loan, the principal must be hiked to cover the insurance premium.

If just the $1776 premium amount were added to the "no-frills" principal of $30,000, the new principal would be $31,776.09. However, that in turn raises the total of payments to $80,051.40, when we hold the 15% note rate and the 180 month term constant. Since the total of payments – part of the formula used to calculate the premium – has now grown, the original premium is too low. So the premium grows yet more. In this sample, it grows 6%, by almost $112 to $1887.98.

a. Adding 5- year truncated credit life, the loan terms now looks like this:

Principal:	$31,890.00	*Itemization:*	*$30,000.00 pay-off old debt* *$ 1,887.98 credit insurance prem.* *$ 2.02 to borrower*[iv]
Interest:	$48,449.40		
Total of payments:	$80,339.40		
Mo. Pmt:	$ 446.33		

i. Adding the insurance added nearly $1900 to the loan principal, which added $2871 to the interest. These increased costs added $26.45 to each monthly payment for 15 years.

3. **<u>Add 7.9 financed points to the "no-frills" loan</u>** (See Table A, column #3)

a. If this borrower were asked to bring 7.9% in points to closing in cash, she would pay $2370 on her $30,000 no-frills loan.

a. Points are financed in the subprime market. By financing the points, the principal is raised, and the points are calculated on higher amount which includes the points themselves, thus raising the dollar value of the points. The compounding in this example raises the dollar value of 7.9 points from $2370 to $2573.43 -- an 8.6% increase.

a. For this borrower to have the $30,000 to cover the debt being refinanced, and pay the lender the 7.9% in points, the loan will look like this:

Principal:	$32,575.00	*Itemization:*	*$30,000.00 pay-off old debt*
			$ 2,573.43 lender points
			$ 1.57 to borrower
Interest:	$49,490.60		
Total of payments:	$82,065.60		
Mo. Pmt:	$455.92		

a. Adding financed points increased the principal from the basic no-frills loan by almost $2600, which added over $3900 to the interest earned at 15% on the loan. The resulting monthly payment is $36 higher.

4. **Add both credit insurance and 7.9% points** (See Table A, column #4)

a. The self-inflating price of each of these charges individually has a cross-effect, inflating each other, as well, when they are financed.

a. Adding both single premium credit life and 7.9% points to her loan, it would look like this:

Principal:	$34,812.00	*Itemization:*	*$30,000.00 pay-off old debt*
			$ 2,060.94 insurance premium
			$ 2,750.15 points to lender
			$ .91 to borrower
Interest:	$52,887.60		
Total of payments:	$87,699.60		
Mo. Pmt:	$ 487.22		

a. Adding both single premium credit life and 7.9% points raised the principal amount from the no-frills loan by 16%, adding over $4800 to the basic $30,000 loan amount. The inflated principal then increased the scheduled interest by $7309.20. The monthly payment, in turn, increased by $67.34.

SUMMARY -- TABLE A

All at 15% note rate (equal monthly installments) -- 180 months				
	# 1- No-frills	# 2 SPCI charged	# 3 – 7.9 points charged	# 4 -- both SPCI & 7.9 points
To borrower				
-Pay-off prior debt	$30,000.00	$30,00.00	$30,000.00	$30,000.00
-cash[v]	0.00	2.02	1.57	0.91

Credit insurance prem		$ 1,887.98		$ 2,060.94
7.9 points			$ 2,573.43	$ 2,750.15
Note principal	$30,000.00	$31,890.00	$32,575.00	$34,812.00
Note interest	$45,578.40	$48,449.40	$49,490.60	$52,887.60
Total of payments	$75,578.40	$80,339.40	$82,065.60	$87,699.60
Monthly payment	$ 419.88	$ 446.33	$ 455.92	$ 487.22

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APPENDIX B
PREPAYMENT: FRONT-LOADING THE COST

Most mortgages pay off early. Lenders can increase their revenues from a given loan during its shortened life by front-loading the loan principal with charges which the lender keeps all or a significant portion of when the loan prepays early. Points, for example, are typically not rebated upon early termination. While "unearned" credit insurance premiums are required in most states to be rebated upon early termination, two factors skew the rebate in lenders' favor. First is the method by which credit insurance rebates are calculated in many states. Many states – if not most – permit credit insurance premium rebates to be calculated by an anachronistic pre-computer formula which favors the lender, the Rule of 78. Second, truncated coverage (insurance in force during only part of the loan term) front-loads the earned portion of the premium. For example, if an insurer wrote 2-year truncated coverage on a 15-year loan, there would be no insurance rebate if the loan were refinanced in three years.

These front-loaded credit costs are embedded in the pay-off balance on the loan. That increases the return on the loan being paid off. If the loan is being paid off by refinancing – part of a flipping sequence, for example – those embedded costs in the pay-off balance carry forward into the new loan, and the inflationary cycle begins anew. In the process, more equity is stripped from the home.

The same loan and variations on it described in Appendix A can be used to illustrate the point. Assume that each of the variations described in A were prepaid at the 36th month.

PREPAYMENT OR REFINANCING AT 3 YEARS ON 15-YEAR LOAN

1. **No frills loan**: (See Table B column #1)

Pay-off balance:	$28,395.07
Interest earned:	$13,090.87
Other credit costs earned:	$ 0.00
Effective cost on $30,000 real loan amount over 3 years:	15%

1. **Single premium credit life insurance:** (See Table B, column # 2)

Pay-off balance:	$29,874.65
Interest earned:	$13,915.64
Other credit costs earned:	$ 1,578.54 (84% of original $1888 credit insurance premium)
Effective yield on $30,000 real loan amount over 3 years:	17.37%

1. **7.9 points** (See Table B, column # 3)

Pay-off balance:	$30,832.34
Interest earned:	$14,214.54
Other credit costs earned:	$ 2,573.43 (100% points considered earned at consummation)
Effective yield on $30,000 real loan amount over 3 years:	18.55%[vi]

1. **Single premium credit life insurance plus 7.9 points** (See Table B, column 4)

Pay-off balance:	$32,612.24
Interest earned:	$15,190.73
Other credit costs earned:	$ 2,750.15 (100%points considered earned at consummation) $ 1,723.15 (84% of credit insurance premium)
Effective yield on $30,000 real loan amount over 3 years:	21.2%[vii]

SUMMARY -- TABLE B

15 % note rate; 180- month term; prepayment at month 36				
	# 1 -- No-frills	# 2 -- SPCI charged	# 3 -- 7.9 points charged	# 4 -- both SPCI & 7.9 points charged
To borrower (pay-off prior debt)	$30,000.00 + 0.00	$30,000.00 + 2.02 cash	$30,000.00 + 1.57cash	$30,000.00 + .91cash
Pay-off balance	$28,044.51	$29,874.65	$30,832.34	$32,612.24
Interest earned	$13,090.87	$13,915.64	$14,214.54	$15,190.73
Other credit costs earned (embedded in the pay-off balance above)	$ 0.00	$ 1,578.54 (84% ins. prem.)	$ 2,573.43 (100% points)	$4,473.30 (Sum of *$ 1,723.15 (84% ins. prem.)* *+$ 2,750.15 (100% points)*)
Total credit cost earned during 3 yrs.	$13,090.87	$15,494.18	$16,787.97	$19,664.03
Effective yield over 3 year term[viii]	15%	17.37%	18.55%	21.2%

APPENDIX C

State v. Household

Standard Petition entered in the Settlement between
50 States and the District of Columbia and Household, International,
December, 2002

The Consent Judgment is available on our web site, and that of many other state attorneys general and financial regulators.

http://www.iowaattorneygeneral.org/latest_news/releases/dec_2002/hhconsent.pdf

The multistate was a joint effort by both state financial regulators and attorneys general, the first such cooperative effort.

IN THE IOWA DISTRICT COURT FOR POLK COUNTY

STATE OF IOWA ex rel. THOMAS J. MILLER, ATTORNEY GENERAL OF IOWA, 99AG25112,	)	**Equity No. CE 45408**
Plaintiff,	)	
i.	)	
HOUSEHOLD INTERNATIONAL, INC. a Delaware corporation,	)	**PETITION AND REQUEST FOR INJUNCTION, RESTITUTION AND OTHER EQUITABLE RELIEF**
Defendant.	)	

Comes Now the State of Iowa ex rel. Thomas J. Miller Attorney General of Iowa, by Assistant Attorney General Kathleen Keest, and brings this action pursuant to the Iowa Consumer Fraud Act, Iowa Code § 714.16. Plaintiff seeks, among other things: a permanent injunction, an order compelling Defendant to pay restitution to consumers and an order reforming contracts between Defendant and Iowa consumers. For its claim, Plaintiff states as follows:

PARTIES, JURISDICTION AND VENUE

1. Thomas J. Miller is the duly elected Attorney General of Iowa. The Attorney General is vested with authority to enforce the Consumer Fraud Act, which prohibits unlawful practices, including "unfair practices" which cause "substantial, unavoidable injury to consumers that is not outweighed by any consumer or competitive benefits which the practice produces," and deceptive practices which have the capacity or tendency to mislead a substantial number of customers as to a material fact or facts. Iowa Code §§ 714.16(1), (2)(a) (2001).

2. In a civil action alleging an unlawful practice the Attorney General has the statutory

authority to obtain injunctive relief, monetary reimbursement for consumers and other relief. Iowa Code § 714.16(7) (2001).

3. Defendant Household International, Inc., a Delaware corporation, and/or its direct and indirect subsidiaries, affiliates, officers, directors, employees, agents, related entities, successors, and assigns (collectively, "Household"), at all times mentioned herein, have transacted business within the State of Iowa, through its consumer lending subsidiaries.

4. Venue is proper in Polk County, Iowa.

5. Pursuant to Iowa R. Civ. P. 1.207, no security is required if the State is seeking injunctive relief.

6. No application for injunctive relief in connection with the business practices of Household has previously been presented by the State to, or denied by, any court.

GENERAL ALLEGATIONS

7. In the ordinary course of its business, direct or indirect subsidiaries of Household Finance Corporation ("HFC"), a subsidiary of Defendant Household International, Inc., have negotiated and entered into real-estate secured loans with consumers in the State of Iowa. These real-estate secured loans with the consumers were made from or at Household's retail lending branches during between the period January 1, 1999 through September 30, 2002 (the "Covered Transactions").

8. State attorneys general and state financial regulators in this state and in other states have received and investigated complaints and conducted examinations concerning the Covered Transactions. Those complaints and investigations related to Household's conduct with respect to the following practices, (collectively, "the Lending Practices"):

A. Two real-estate secured loans made at or near the same date to the same consumer ("split loans," or "loan splitting"): Plaintiff alleges that such loans were made through unfair and deceptive means, including, but not limited to, misrepresentations or omissions concerning the number of loans, misrepresentation of the benefits of refinancing and debt consolidation with the high-cost split loans; and as a means to make high loan-to-value mortgage loans which had the effect of preventing borrowers from seeking to refinance with lower rate lenders.

B. Loan points and origination fees: Plaintiff alleges that Defendant failed to provide timely and adequate information to borrowers concerning the amount and purpose of the putative "discount" or "buy-down" points and fees imposed on their loans, including, but not limited to, failing to provide meaningful early disclosures as required by law, 24 C.F.R. § 3500.7.

C. Misrepresentation of interest rates: Plaintiff alleges that Defendant misrepresented the interest rates to be charged on loans through such means as using a "low-ball" rate purporting to be an "effective" rate, or equally deceptive term. Such misrepresentations and omissions occurred in the context of Defendant's attempting to disguise a high-rate mortgage as a low-rate mortgage through use of (for payment of an additional fee) a bi-weekly payment plan. Plaintiff failed to inform consumers that accelerated principal reduction occurred through making extra payments, instead misleading consumers into thinking the savings were attributable to lower interest charges than the loans provided for. Additionally, misleading comparisons were made between rates on existing debts which applicants were considering refinancing or consolidating, and the rate(s) to be charged on Defendant's proposed loan or loans.

D. Monthly payment amounts: Plaintiff alleges that Defendant failed to inform consumers that higher payments, rather than lower rates, were the feature of the bi-weekly payment program which would result in overall savings in finance charges. Further, in making sales presentations with respect to refinancing and debt consolidation applications, Defendant made misleading comparisons of monthly payment obligations between existing debts and the proposed new loan or loans to be made by Defendant.

E. Single premium credit and other insurance product: Plaintiff alleges that Defendant engaged in a pattern of "insurance packing," including, but not limited to, misleading consumers as to the voluntary nature of the insurance, to the price of the insurance, and the benefits and/or term of the insurance.

F. Prepayment penalties: Plaintiff alleges that Defendant engaged in a practice of misleading consumers about the presence of prepayment penalties on their loans.

G. Unsolicited loans offered through an unsolicited negotiable check that the consumer can accept by endorsing and depositing or transferring the check ("live checks"): Plaintiff alleges that Defendant used "live checks" as a "bait" to make high-cost mortgage loans; used misleading representations, such as that the receipt of a live check constituted a "guaranteed loan approval," and failed to adequately inform consumers that the unsolicited check was a loan.

H. Practices with regard to home equity lines of credit: Plaintiff alleges that Defendant extended what was in substance closed-end credit disguised as open-end credit with the intent to avoid making meaningful disclosures concerning the payment terms, such as the existence of large balloon payments. Plaintiff further alleges that Defendant extended what was in substance closed-end credit with APRs in excess of 10% over the US treasury rate for comparable maturities, disguised as open-end credit to evade the requirements of the Home Ownership and Equity Protection Act, 15 U.S.C. § 1639.

I. Loan billing practices relating to simple interest calculations: Plaintiff alleges that Defendant's practices by which payments were credited to accounts on the basis of the number of days between payments frequently resulted in situations in which scheduled payments were insufficient to pay accrued interest, creating a shortfall in interest ("interest short"), which resulted in excess finance charge costs for borrowers. Such shortfalls could occur even when payments were not late. Defendants further made representations concerning the opportunity to "skip a payment," without informing consumers that such would result in "interest short" situations. Defendants failed to provide borrowers with material information necessary to avoid such extra charges.

J. Balloon payments: Plaintiff alleges that Defendants extended credit to borrowers which would eventually require balloon payments, without disclosing to borrowers the existence or amount of the balloon payments.,

K. Pay-off information: Plaintiff alleges that Defendants failed to provide timely pay-off information, which impeded borrowers' efforts to seek refinancing elsewhere.

L. Non-English language documentation: Plaintiff alleges that Defendants engaged in unfair and deceptive practices by failing to provide meaningful descriptions of loan terms to non-English-speaking borrowers.

M. Net tangible benefit in loan refinancing. Plaintiff alleges that Defendants engaged in the practice of refinancing its own or other loans, thereby imposing additional fees and costs, where the new loan provided no net tangible benefit to the consumer.

UNFAIR AND DECEPTIVE PRACTICES
IOWA CODE § 714.16

9. Plaintiff realleges and incorporates by reference the allegations of Paragraphs 1 to 8 of this Petition.

10. Defendant, through its direct or indirect subsidiaries, engages in trade or commerce in connection with the sale of intangible "merchandise" within the meaning of Iowa Code § 714.16, by making loans to consumers in "sub-prime" mortgage loan market. Defendant advertises, offers, solicits sales of, and sells real estate secured loans and related goods and services to Iowa consumers.

11. Defendant, through its direct and indirect subsidiaries, engaged in the business of making loans to Iowa consumers that were secured by those consumers' homes. Defendant used misleading unfair or deceptive promotions, marketing and sales techniques to induce primarily low and moderate-income homeowners to refinance their mortgages and consolidate their debts using Household's real-estate secured loan products.

12. In the course of its dealings with consumers and in furtherance of its own direct pecuniary and business gains, Defendant committed deceptive or unfair acts, or made material misrepresentations or omissions in violation of Iowa Code § 714.16(2)(a).

WHEREFORE, the Attorney General prays that the court:

A. Permanently enjoin Defendant, its direct and indirect subsidiaries, affiliates, officers, directors, employees, agents, related entities, successors, and assigns, and any and all other persons who act under, by, through, or on behalf of Defendant, pursuant to Iowa Code § 714.16(7), from:

(1) Making or disseminating any misleading unfair or and deceptive representations in violation of Iowa Code § 714.16(2), relating to the marketing or sale of loans to consumers.

(2) Engaging in unfair and deceptive practices referenced in the Petition, in violation of Iowa Code § 714.16(2).

B. Order the Defendant make restitution pursuant to Iowa Code § 714.16(7) to consumers who paid or are obligated to pay money to Defendant under circumstances alleged herein to be in violation of Iowa law.

C. Order the Plaintiff be awarded such recompense as is authorized under Iowa Code § § 714.16(7), (11).

D. That the Plaintiff be awarded such other and further relief as the Court deems just and proper and is equitable under the circumstances.

Dated:

[December 12, 2003]__________________

THOMAS J. MILLER
Attorney General of Iowa

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By:

<u>S/</u>

[****]
Assistant Attorney General
Consumer Protection Division
1305 E. Walnut Street
Des Moines, IA 50319
Phone: 515-281-5926

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[i] A complete amortization table would show a precise payment schedule of 179 payments of $419.88 plus 1 final payment of $417.11. To simplify matters, all of these sample runs use 180 equal payments.

[ii] If gross coverage insures the entire total of payments, that is the figure used. If the insured amount is something other than that, the initial insured indebtedness amount is substituted. For example, there may be a $100,000 insurance maximum, though the total of payments might be $110,000.

[iii] This was the rate in effect in Illinois recently for single decreasing term credit life.

[iv] There are minimal cash outs because the additional calculations necessary to bring that to $0 for purposes of this illustration were not worth the time. They are too small to make a meaningful difference in the underlying points being illustrated in these Appendices.

[v] See Appendix note 4, *supra.*

[vi] The originally disclosed APR on this loan would have been 16.73%, reflecting the points as a finance charge.

[vii] The originally disclosed APR on this loan would also have been 16.73%.

[viii] This effective yield calculation ignores the minimal cash amounts.

CFAL COALITION FOR FAIR AND AFFORDABLE LENDING

Testimony of Steve Nadon
Chairman of the Coalition for Fair and Affordable Lending (CFAL)
& Chief Operating Officer of Option One Mortgage

on

"Protecting Homeowners: Preventing Abusive Lending While Preserving Access to Credit"

before the

Subcommittees on Housing and Community Opportunity & Financial Institutions and Consumer Credit

of the

Committee on Financial Services
U.S. House of Representatives

November 6, 2003

Introduction & Summary Overview

The Coalition for Fair and Affordable Lending[1] ("CFAL") appreciates the opportunity for me to testify on its behalf at today's hearing. I am Steve Nadon, CFAL's Chairman, and Chief Operating Officer of Option One Mortgage, which is a subsidiary of H&R Block and is one of the nation's largest nonprime mortgage lenders.

First, I want to commend Chairman Ney and Chairman Bachus for scheduling today's hearing so that House Financial Services Committee Members can hear suggestions from interested parties on how Congress can best prevent abusive lending practices and at the same time not limit access to affordable mortgage credit.

Without question, some lenders and mortgage brokers engage in inappropriate lending practices that need to be stopped. Many of these abuses are fraudulent, deceptive and illegal. Enhanced enforcement together with more consumer financial education and counseling opportunities are needed to help prevent them. However, significant new

[1] The Coalition for Fair and Affordable Lending (CFAL), launched January of 2003, was formed to advocate national, uniform fair legislative standards for nonprime mortgage lending. CFAL's members make around one-third of all nonprime mortgage loans.

CFAL Coalition for Fair and Affordable Lending

federal statutory requirements also are needed to remove gaps or weaknesses in current law.

CFAL believes that it is imperative that Congress promptly pass such new federal requirements. H.R. 833, the Ney-Lucas bill, effectively addresses many of the current law's shortcomings. We urge Members to work together after the November 5th hearing to further refine H.R. 833 as may be needed to address any additional concerns and gain broader bipartisan support. We want to work constructively with you and other interested parties to help craft a fair and balanced refined legislative proposal that can be the basis for the new federal law and that the full Committee can act on early next year.

The arbitrary and irrational growing patchwork of state and local laws intended to prevent mortgage lending abuses is proving to be unduly burdensome and costly. Moreover, federally chartered depositories, as well as some state chartered entities, are being exempted from these state and local laws' requirements. This creates not only an unlevel regulatory playing field for lenders, but also confusion and inconsistent levels of protection for borrowers. Many consumers are not being adequately or equally protected by these measures, and the national housing finance market is being disrupted.

Accordingly, CFAL thinks that the new federal fair lending rules should apply uniformly so that all mortgage lenders are governed by them and that every American borrower receives the same effective protections. And, we want to see both federal and state regulators actively enforce these nationwide standards.

Congress clearly has the power to pass legislation providing for uniform national standards for nonprime lending. We believe that such uniform rules are badly needed and that it is sound public policy for Congress to establish them.

As Committee members know, housing is critically important to our nation. Not only is home ownership "the American dream," and central to the welfare and stability of families and communities, it is vital for our nation's economy. Housing has been an essential economic engine for us. Millions of Americans rely on their home equity to help meet their credit needs, and this is especially important during tighter economic times. We clearly need to ensure that they are not abused in the mortgage lending process, but we also must make certain that "protective" measures do not harm them by limiting their access to needed credit or unnecessarily increasing its cost.

Today's nonprime mortgage industry has truly become an interstate business that is increasingly dominated by large nationwide lenders. The primary reason that this business has grown dramatically in the last decade and has been able to provide credit at relatively low rates to millions of Americans who could not have qualified for conventional financing is the development of a strong secondary market for nonprime loans. Our industry has become much more automated, standardized and efficient, and now securitizes the majority of the loans we originate. About 65% of the $213 Billion in

CFAL Coalition for Fair and Affordable Lending

nonprime mortgages originated last year were securitized. Securitization has let us bring in vast amounts of capital from the national and global markets. This has both enabled us to make far more credit available and to dramatically decrease the rates we charge borrowers. However, overreaching legislation, regardless of how well-intended, can easily disrupt our capital markets, and have a horrendous adverse impact on both credit availability and borrowers' credit costs. Unbalanced legislation can also hurt not only those who it is primarily intended to protect (e.g., those perceived as being most vulnerable), but it can also injure the many other people who make up the larger part of the overall nonprime market.

Simply put, housing and housing finance is very special and important for both personal and national interests. In order to continue making reasonably priced mortgage credit available to more and more Americans, industry needs clear, consistent and workable lending standards, not a hodgepodge of differing and often inappropriate restrictions. Congress, starting with this Committee, is in the best position to set such standards, and we ask that you do so.

CFAL's members are flexible and open to compromise and reasonable changes to the initial Ney-Lucas proposal as a part of an overall refined bipartisan proposal that provides fair uniform national standards. Among other things, we believe that workable refinements could:

- ✓ Cover many more loans;
- ✓ Further restrict prepayment penalties;
- ✓ Enhance "anti-flipping" requirements;
- ✓ Provide an effective right to cure unintentional violations;
- ✓ Impose very tough penalties for intentional violations;
- ✓ Address assignee liability concerns while ensuring that borrowers have effective recourse when violations occur; and
- ✓ Increase funding for state and federal enforcement efforts and for expanded consumer education and counseling services.

Before outlining how the current federal law should be changed and strengthened, I will explain a few important points about nonprime mortgage lending.

"Nonprime" Lending *Products* vs. "Predatory" Lending *Practices*

Literally millions of Americans are unable to qualify for the lowest rate mortgages available in the so-called "prime"[2] (a/k/a "conventional" or "conforming") market because they have less than perfect credit, or they can not meet some of the other tougher underwriting requirements of the prime market. These borrowers, who generally

[2] The term "prime" in the mortgage context does not refer to the "prime" interest rate that banks charge their best customers for loans; instead, it refers to the lower rate that mortgage lenders charge the lowest risk borrowers who qualify for mortgages that are bought by Fannie Mae and Freddie Mac, the two large housing government sponsored enterprises ("GSEs").

CFAL COALITION FOR FAIR AND AFFORDABLE LENDING

are considered as posing higher risks, must rely on the so-called "nonprime"[3] market which offers many more customized mortgage *products* to meet customers' varying credit needs. And, as one would reasonably expect, they will pay a somewhat higher rate to offset their greater risk. Substantially higher servicing costs also increase the costs of these loans. It is in this "subprime" or "nonprime" lending segment where most concerns over improper lending practices have been raised.

"Predatory lending" is how many people refer to a variety of lending *practices* that may involve actual or perceived abuse with regard to the sale of nonprime mortgage *products*. Although "predatory lending" is a generic term without precise definition,[4] it has been used to describe these questionable practices because the perpetrator often is said to "prey upon" people who are more likely to be vulnerable or desperate for credit.

Due in part to earlier misleading, but widely circulated media stories, as well as the actual higher level of abusive practices that have occurred in this nonprime part of the market, many parties have unfortunately confused "nonprime" *products* with "predatory" *practices*. Accordingly, some have thought "nonprime lending" literally was the same as "predatory lending", failing to recognize that abuses are *practices* occurring in only a relatively small portion of the overall nonprime *product* market. Although this misperception today is far less prevalent than several years ago, this confusion still clouds the public policy debate.[5]

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[3] Customers who are viewed as posing higher risks, for a variety of reasons----most often because of some defects in their credit records, are considered to be of lesser credit quality or below "prime" and hence are termed "subprime" or less pejoratively, "nonprime" borrowers. *"Banking regulators generally designate a 'subprime' borrower as having one of the following characteristics: two or more 30-day delinquencies in the last 12 months; one or more 60-day delinquencies in the last 24 months; judgment, foreclosure, repossession, or charge off in the prior 24 months; bankruptcy in the last 5 years; a high default probability as measured by a credit score of 660 or below; or a debt service-to-income ratio of 50% or greater. (See OCC Bulletin 2001-6.) Generally, a credit score of 680 qualifies a borrower for consideration for a prime loan, whereas a score below 620 virtually eliminates the possibility."* OCC working paper "Economic Issues in Predatory Lending" (July 30, 2003) (hereinafter cited as "OCC Analysis"), p. 8.

[4] *"There is no single, generally accepted definition of a 'predatory loan.' Indeed, disagreements over the definition of predatory lending have often served to confuse the debate over this issue.... The term has been employed loosely by community groups, policymakers and regulators to refer to a wide range of practices.... Within the academic literature on predatory lending, economists typically suggest that judgments as to whether a loan's price is high or abusive in the absence of additional concrete economic analysis of underlying risks, costs and other fundamentals, such as the level of demand for credit, are not a valid basis for defining predatory lending. These analysts point out that without a precise definition, many of the published figures on predatory lending abuses become less convincing. There have been a variety of estimates on the societal costs of predatory lending released in the media. However, a closer examination of some of these studies suggests that with even slight definitional or methodological changes, a case could be made for significantly smaller estimates of abusive lending costs."* OCC Analysis, p. 6.

[5] Most consumer advocates now admit that "nonprime lending" should not be equated with "predatory lending", and that legitimate nonprime lending has "democratized" credit and helps millions of Americans who can not qualify for prime mortgage rates meet their credit needs. They claim that they are only trying to stop the abusive practices, not legitimate lending. But, by their actions (i.e., the overly restrictive

In any case, it is important for policy makers to understand that "nonprime" mortgage lending is, for the most part, not only wholly legitimate and non-abusive, but also critically important for meeting the credit needs of the millions of Americans who are unable to qualify for "prime" mortgage credit. This nonprime market last year amounted to at least $213 billion, or about 10% of the overall mortgage market. Over half of these loans were originated through brokers, and about 65% were sold into the secondary market and securitized. Today, one of the major reasons for the availability of nonprime credit and its relatively low rates is this securitization process. Securitization has provided the capital from the national and international markets to fund these higher risk loans. This has made mortgage credit much more available and dramatically decreased costs to borrowers. As Federal Reserve Board Governor Gramlich said in a recent speech:

"One of the important stories of the 1990s was the huge growth in subprime lending. In dollars, subprime mortgage originations grew by a factor of seven over the 1994-2002 period. Since low-income and minority borrowers are much more likely to rely on subprime credits, these groups have benefited disproportionately from the expansion. One visible outcome has been an increase in home ownership rates for low-income and minority borrowers. This represents a welcome extension of home mortgage and other credit to previously underserved groups--a true democratization of credit markets. Millions of low- and moderate-income families now have a chance at owning a home and building wealth. This rapid growth of subprime credit may have created problems..., but there is plenty of good news in this area." [6]

"Nonprime" Customers

Contrary to common misperceptions and some parties' erroneous contentions, "nonprime" borrowers are not primarily extremely poor and desperate minorities and senior citizens. In fact, most are in their 40s and 50s, have incomes in the $50,000 - $75,000 range, and are not minorities. In many cases, they again become "prime" customers after experiencing temporary problems because of some adverse life event (e.g., a divorce; job loss; or serious medical illness). In others, they may remain unable to qualify for lower prime rates due to ongoing poor management of their finances, or a tendency to periodically become overextended economically. And in many situations, the borrower may have good credit, but might not meet certain of the other strict underwriting requirements for prime loans (e.g., inadequate income documentation; limited down payment or cash reserves; or the desire to take more cash out in a refinancing than conventional loans allow).

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legislative provisions that they are advocating) many advocates indicate that they in fact favor significantly curtailing nonprime credit availability.

[6] Remarks of FRB Governor Edward Gramlich, *"An Update on the Predatory Lending Issue"* (October 9, 2003).

Although they pose somewhat higher risks than prime rated customers, and sometimes are slower paying, the vast majority of nonprime borrowers pay in a timely manner and they are good customers. Nonprime lenders utilize risk-based pricing and generally charge rates that vary based on the particular customer's risk level.[7] Overall, these customers now are given loan products that have average rates only about 2% higher than prime rates, and many are only a fraction of a percent more. This is a far cry from the 15% to 20% rates many people mistakenly think are charged by most nonprime lenders.

How HOEPA Works (and Doesn't Work)

In 1994, Congress recognized that higher risk mortgage borrowers may be more likely to be subject to more coercive or inappropriate lending practices. Accordingly, it then passed the federal Home Ownership and Equity Protection Act ("HOEPA")[8] to provide additional disclosures and substantive protections for certain of the highest cost mortgage loans.

HOEPA applies only to certain "closed-end" loans (a/k/a "HOEPA loans") for refinancing prior loans that "trigger" its provisions by having annual percentage rates ("APRs") above a set level or "points and fees" in excess of a specified percentage of the loan amount.[9] HOEPA does not apply to loans made to purchase a home, or to loans that are structured on an "open-end" basis.

In addition to special warning disclosures, loans subject to HOEPA and its implementing regulations have certain limitations or prohibitions on contract terms or sales practices such as prohibiting: negative amortization, which occurs when the payments made do not reduce the principal balance; increasing interest rates upon default; balloon payments on loans less than 5 years; payments made only to a home improvement contractor from loan proceeds; refinancing within 12 months unless it is in the borrower's "interest"; and making loans without regard to ability to repay on a "pattern and practice" basis. HOEPA also applies expanded assignee liability on covered

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[7] *"[T]he gap between prime and subprime rates is largely explained by differences in risk and servicing costs between the two markets and that subprime rates therefore do not appear to be particularly out of line with underlying risk and cost considerations....The risks and costs associated with subprime lending are significantly higher than those in the prime sector. These factors account for the lion's share of the pricing differential between subprime and prime mortgages. In addition, there are indications that demand for subprime credit is currently outstripping available supply....Therefore, the empirical data do not support the contention that subprime providers are earning economic rents [a/k/a "abnormally high profits"].* OCC Analysis, pp. 13, 16-17.

[8] 15 U.S.C. §§ 1602(aa), 1639. Implementing HOEPA regulations issued by the Federal Reserve Board can be found at 12 C.F.R. § 226.32.

[9] HOEPA's APR triggers are 8% for first liens and 10% for junior liens. The law's points and fees trigger covers loans when the total points and fees (counting only certain specified items) exceeds 8% of the total loan amount, and exceeds an indexed base amount, which is $488 for 2003 ($499 for 2004).

loans for essentially ALL claims and defenses that the borrower could have raised against the loan originator, including those arising under other statutes and common law.

Although HOEPA does provide some limited safeguards, it now generally is accepted that this federal law has serious defects.

Advocates' Concerns - Advocacy groups essentially contend that HOEPA is inadequate because it: (1) applies to only a relatively small portion of higher cost loans; and (2) fails to mandate many substantive protections that are needed to prevent certain abusive practices.

Industry's Concerns – Responsible lenders acknowledge that HOEPA does not contain some restrictions that are needed to protect borrowers from certain abusive practices. However, they note that the current statute also is fundamentally flawed because it: (1) includes unclear requirements so lenders may not know what they must do; (2) fails to provide a meaningful "right to cure" unintentional errors; (3) mandates unduly severe penalties; and (4) imposes liability on assignees who could not reasonably know of violations.

HOEPA's Perverse Effects - It is now widely recognized that HOEPA has the practical effect of <u>prohibiting borrowers from being able to obtain legitimate nonprime loans instead of simply restricting inappropriate practices</u>. Few lenders make loans that are subject to this statute and there are virtually no secondary market purchasers of the relatively few that are made.[10] The HOEPA loans that are originated are held by portfolio lenders who are likely to charge an even higher price *due not to the borrower's credit, but to the higher legal and reputational risks and reduced competition caused by the law itself!*

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[10] HOEPA poses two types of risk for legitimate lenders. The first is *reputational* (i.e., concerns whereby companies do not want to have their reputations hurt by being associated with loans that may be perceived as "high cost"). More frequently, however, the concern has to do with the *legal* risk that arises from HOEPA's provisions. In practice, given how the current restrictions are worded, the main compliance problem here has little or nothing to do with the limitations on practices such as loan flipping, repayment ability or negative amortization. The problem is that lenders sometimes inadvertently miscalculate whether or not certain loans cross HOEPA's thresholds. This puts them in a "got you" situation as they will not have given the required special HOEPA disclosure notice which has to be given before the loan is made. There is inadequate provision for correction in this case or for most other unintentional mistakes. This means that the lender has violated the law. Penalties include having the loan rescinded at any time during its first three years and being required to refund all fees and payments made by the borrower. Lenders understandably consider this an extremely severe penalty, and many do not think it is worth the risk of making loans in these circumstances. Moreover, HOEPA's sweeping assignee liability provisions mean that secondary market purchasers would likewise be liable for such a miscalculation or other unintended violation about which they neither knew, nor reasonably could have known. Not surprisingly, therefore, there is virtually no secondary market and no securitization of HOEPA loans. And, as noted above, only certain portfolio lenders make these loans, and when they do it generally is at higher rates due not to the borrowers' credit risk, but to the law's risks.

CFAL COALITION FOR FAIR AND AFFORDABLE LENDING

The bottom line here is that for many of the most needy borrowers, HOEPA's "protections" are providing relatively little real benefit, and it is likely to come at higher costs due to the law's provisions. We seriously question whether this is what Congress intended, and recommend that Congress restructure as well as broaden HOEPA so this perverse effect is not allowed to continue.

State & Local Initiatives

Congress has failed to update HOEPA despite widespread acknowledgment among both consumer advocates and industry groups that statutory changes are needed. Not surprisingly therefore, starting in 1999 with North Carolina[11] many states and localities have enacted, or are seriously considering enacting their own laws to prohibit perceived abusive mortgage lending practices.[12]

Some of the enacted and proposed state and local measures include two significant types of loans that are not covered under HOEPA: (1) loans for the purchase of a home (a/k/a "purchase money loans");[13] and (2) open-end loans (e.g., home equity lines of credit where the amount of the loan can go up and down and the borrower is not initially paying off the loan by amortizing the amount by set payments over a set number of months).[14]

In most cases, the state and local initiatives use the federal HOEPA law's threshold / trigger-based model as the general framework on which they overlay their own requirements. In essence, these non-federal laws include "trigger" provisions that provide that nonprime mortgage loans that have annual percentage rates ("APRs") above a certain level or "points and fees" in excess of a specified percentage of the loan amount are subject to the state or local law's requirements.

[11] Many advocates have contended that the NC law should serve as the model for other state laws, or even for a revised federal HOEPA. In that regard, it is worth noting that although some states essentially started with proposals close the NC statute, significant changes have been made elsewhere during the legislative process. Thus, for example, by the time the Georgia Legislature finished with it's work on the first version of that state's law, key NC concepts had "mutated" like a SARS virus---e.g., assignee liability and draconian penalties were added; limitations on the anti-flipping "net benefit" test were removed. Subsequent analysis also has shown the NC law and its impact may be quite a bit different and less favorable than its proponents have asserted. *See* OCC Analysis at pages 18-22; 24-25; and *"Trigger Happy: Enactment And Aftereffects Of North Carolina's 'Predatory Lending' Law,"* by Donald C. Lampe (July 2003) (copy available on CFAL's website).
[12] See the information on CFAL's website regarding various state/local measures at: http://www.cfal.ws/resources.htm .
[13] For example: California; Georgia; Kentucky; New Jersey; New Mexico; New York; North Carolina; South Carolina.
[14] For example: Arkansas; Connecticut; Georgia; New Jersey; New Mexico; New York; North Carolina.

The more restrictive[15] laws lower the trigger percentages so that they apply to far more loans than the federal law. In particular, the "points and fees" trigger is often significantly lowered by both decreasing the percentage number (e.g., 8% to 5%) and by including more items within the definition of a "fee" so the percentage is exceeded more often (e.g., by counting indirect broker compensation). Thus, in real terms, the percentage reduction is far greater than at first may appear (e.g., 8% to 5% really in effect can be about 3%).

Sometimes, in addition to "high cost" loans, a second category is created (typically called "covered" loans) where certain loans are subject to some, but not all the requirements that apply to the very highest cost loans. The requirements in either case generally include restrictions on additional practices and/or more stringent restrictions than those found in the federal HOEPA law.

What is especially important to understand for present purposes is that NONE of these various state and local laws are the same. Requirements differ widely. Moreover, not only is there a patchwork of different state/local laws, but some quite frankly are too weak, failing to provide adequate protections. Others are excessive, imposing undue requirements and unnecessarily limiting credit availability. And, MOST states do not have laws that effectively plug HOEPA's gaps.

There is no question but that some nonprime borrowers are subjected to inappropriate practices which should be prevented. There also is no question but that vast numbers of borrowers who are not victims of such practices can become victimized by poorly crafted "protective" legislation that restricts nonprime credit availability or unnecessarily increases its cost.[16] This unfortunately is occurring in all too many cases where state and local "anti-predatory lending" laws are being passed.[17] Legislators therefore need to exercise care to ensure that they do not unintentionally curtail well-priced, affordable nonprime credit from legitimate, responsible lenders, or make it more

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[15] One point that should be understood is that the often-made claim that a harsher state law provides "greater consumer protection" than HOEPA or another state's law can be very misleading. Different, "more restrictive," or "tougher" do not necessarily mean "better" or more appropriate protection of borrowers' interests. In fact, the opposite may be true. Sometimes more actual protection is provided. Other times the law is so restrictive that legitimate practices or products are prohibited, and it is against consumers' interests for this to occur. Put another way, "greater protection" labels may be more political advocacy terms used all too often to disguise unbalanced legislation that can hurt, more than help, many borrowers.

[16] As noted in the OCC Analysis, *[t]here is a good deal of empirical evidence to suggest that anti-predatory statutes impede the flow of mortgage credit, especially to low income and higher-risk borrowers, and any reductions in predatory abuses resulting from these measures is probably achieved at the expense of many legitimate loans."* OCC Analysis, p. 20.

[17] In Georgia, for example, we saw the Legislature pass a very onerous bill that resulted in a literal shutdown of nonprime mortgage lending in that state. After this occurred, Georgia legislators had to pass major amendments to correct some of the worst excesses. We now are about to see other major market disruptions due to well-intended but unworkable laws in New Jersey, Los Angeles and Oakland.

expensive. With careful drafting and balanced provisions, however, they can prevent abuses while preserving credit availability.

Finding Workable Solutions and Setting Balanced Lending Standards

Congress should act to bridge the gap that exists between what is in HOEPA and what actually is needed to prevent real abuses. It also should refine certain of HOEPA's provisions to make the law more workable. From a technical perspective, we think that it is relatively easy to draft language that effectively prohibits abusive practices while allowing legitimate nonprime lending to continue. The more difficult question, however, has been whether there is enough political will and discipline to adopt appropriate changes. We believe that there is a growing bipartisan willingness to do so.

Areas of Substantial Agreement - There are a significant number of areas where there appears to be little or no substantial disagreement between advocacy groups and industry. Also, I believe that it is quite important to highlight what many apparently have not realized: *the Ney-Lucas bill as introduced addresses most of these and other questionable practices. And, the bill generally does so effectively, although on some points the bill's provisions may merit further "tweaking" or refinements.* For purposes of today's testimony, I will only briefly highlight the less contentious issues in the chart below and then direct the remainder of my testimony to major issues where Committee members must weigh various options and then make policy choices.

AREAS OF SUBSTANTIAL AGREEMENT	COMMENT
Add New HOEPA Prohibitions on	**✓ = in H.R. 833**
Call / Debt Acceleration Provisions	✓
Modification or Deferral Fees	✓
Short-Term Balloon Payment Provisions	✓ HOEPA & H.R. 833 prohibit less than 5 years; this might be extended to 7 years
Increasing Interest Rate Upon Default	✓
Bad Faith Avoidance of HOEPA's Restrictions	✓
Lending Without Special Warning Disclosures	✓ H.R. 833 adds stronger warnings to current HOEPA disclosure
Recommending or Encouraging Default	✓
Negative Amortization	✓
Charging Fees for Payoff Balance	✓
Home Improvement Lending Without Additional Safeguards	✓
Single Premium Credit Life Insurance	✓ H.R. 833 prohibits single premium "insurance policies" but additional language might be added to clarify that the prohibition also applies to similar or functionally equivalent products like "debt cancellation agreements" that technically might not be "insurance

CFAL COALITION FOR FAIR AND AFFORDABLE LENDING

	policies" under state law
Lending Without Regard to Repayment Ability	✓ H.R. 833 significantly enhances HOEPA's current restriction by removing the "pattern or practice" requirement; the bill applies a 53% debt-to-income test (which is a compromise between 55% urged by industry and 50% urged by advocacy groups)
Profiting from Foreclosures	✓ H.R. 833 would add a significant innovation to HOEPA by prohibiting lenders from profiting from foreclosures; any equity remaining after foreclosure costs would be given to the borrower
Lending Without Reporting to Credit Bureaus	✓
Refinancing Below-Market Low Interest Rate Loans	✓

Issues Requiring Further Consideration - I now will highlight some of the key problems that Congress needs to address, and will suggest some possible solutions and identify certain questions that may merit further consideration. CFAL believes that in most cases, the policy choices are reasonably clear, and thus it should be possible to develop reasonable and workable bipartisan solutions on most issues without great disagreement.

LOAN ORIGINATION-RELATED ISSUES

➢ **Restricting Prepayment Penalties** – Prepayment penalties are fees that are charged when a borrower pays off a loan earlier than had been agreed when the loan was made. Prepayment penalties are part of a lender's fundamental pricing consideration. Loan pricing is based on having loans on the books long enough to recover various origination costs that are amortized through the planned and agreed upon number of monthly payments. When the loan has a prepayment penalty, either the rate or the points the borrower pays will be lower; if no penalty applies, they will be higher. Thus, by utilizing a prepayment clause a lender can make a loan more affordable for many cash-strapped consumers.

CFAL believes that there is nothing inappropriate about a prepayment penalty that is properly disclosed and fairly structured, and that borrowers can receive major benefits from such provisions primarily through lower interest rates. However, we also recognize that sometimes prepayment penalty features are not adequately disclosed and explained to customers. In some cases the time duration of the penalty and the penalty amount may be excessive.

Thus, we support adding further reasonable limitations on prepayment penalties. In crafting such limitations, it is important for Committee members to ensure not only that the penalty is not excessive, but also that it is in fact enough to allow the lender to give the borrower who accepts it a significant benefit (e.g., a lower interest rate).

H.R. 833 makes a good start at addressing the prepayment penalty issue by limiting penalties so that they can not apply longer than 4 years instead of 5 years as HOEPA allows. CFAL believes that the Committee should further refine these limitations as follows:

1. **Informed Choice** - If a loan is offered with a prepayment penalty, the borrower always should be given the choice of a loan without the penalty, and the penalty should be clearly disclosed and explained to the borrower;
2. **Maximum 3-Year Time Limit** - The time duration of the penalty should be limited to a maximum of 3 years (or 2 years where an adjustable rate product is involved); and
3. **Amount Limit** - The amount of the penalty should be limited to what is allowed by California's law, which is 6 months interest on 80% of the outstanding loan balance.

- **Prohibiting "Loan Flipping"** – When a loan is refinanced frequently with the borrower receiving no real benefit and paying loan closing fees and costs that have the effect of stripping away the borrower's equity, loan "flipping" is said to occur. There is no question that flipping has been a significant problem. Consumer advocates and lenders agree that loan "flipping" is abusive and should be prohibited. There is disagreement, however, on how this should be done.

  Under implementing regulations issued by the Federal Reserve Board, HOEPA essentially prohibits covered loans from being refinanced by the same lender within 12 months "unless the refinancing is in the borrower's interest."[18] The regulations indicate that this determination is to be made on a case by case basis taking into account relevant circumstances.

  Consumer groups usually favor using a differently worded test and applying it to loans for a much longer period of time. In particular, advocates argue that the statutory test should be that the loan should not be made unless there is a *"reasonable tangible net benefit"* to the borrower. This phraseology was first used in the North Carolina "anti-predatory lending" statute.[19]

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[18] 12 C.F.R. § 226.34(a)(3).

[19] As noted earlier, there has been much discussion, pro and con, regarding the NC statute. Suffice it to say here that experience has shown that no reputable lenders are known to be making loans that are deemed "high cost" under this law. This NC law has significant qualifications on this test (*e.g., a requirement that the flipping violation be "knowing" or "intentional" and a limitation on the ability of a plaintiff's attorney to collect attorney's fees if a reasonable settlement of a dispute is rejected*) that have made the law such that most lenders can continue to do business, albeit not in the "high cost" area.

CFAL's members and other lenders certainly want to stop loan flipping, but feel strongly that there are better ways of crafting an effective restriction than using an undefined "tangible net benefit" test. [20]

CFAL believes that Congress should recognize that however the flipping test is worded, clear statutory guidance should be given so that lenders can know with reasonable certainty what they are required to do. Providing such guidance is fair to all parties, facilitates compliance and enforcement, and helps avoid unnecessary and costly lawsuits. We suggest that the Committee's basic approach for crafting such a test should involve:

(1) choosing the most suitable wording----"*identifiable benefit,*" which is used in California's law and is proving to be workable is significantly clearer than "tangible net benefit," which seems to require some type of unspecified mathematical netting calculation;

(2) regardless of the term used, including NC's key qualifications (i.e., that the flipping be "*knowing or intentional*" and that the awarding of attorney's fees be limited to encourage settlements and discourage lawsuits);

(3) providing a number of specific "safe harbor" examples to give lenders meaningful guidance on what is intended to be an acceptable "benefit"; and

(4) setting a reasonable limit on the length of time the "flipping" restriction applies (e.g., 2 years).

- **Financing Points and Fees** – Many consumer advocates assert that lenders are engaging in a "predatory" practice when they allow customers to borrow the money needed to pay mortgage closing costs and finance these costs as a part of the total loan amount. These advocates contend this has the effect of stripping away the borrower's equity. They argue that nonprime lenders should instead be required to incorporate all closing costs into the loan interest rate.[21]

CFAL's members and other lenders have a fundamental disagreement with these advocates' position, which we consider extreme and against consumers' best interests.[22] Nonprime borrowers rarely have extra cash available to pay

[20] Some parties favor using the somewhat different approach of simply imposing a very tough but relatively short term (e.g., 1 year) prohibition on refinancing a "high cost" loan with another "high cost" loan (as is done in H.R. 833). CFAL would find such a restriction workable and believes it would be effective during its term. However, we recognize that many parties are insisting on a longer term "borrower benefit" test of some type.

[21] In fact, in a joint letter to House Financial Services Committee Chairman Oxley, many of the most active national advocacy groups termed such financing as "the most egregious predatory lending practice." Thus, it appears they are contending that all nonprime lenders are engaging in predatory practices since all such lenders, as far as we know, allow borrowers to finance such costs. The same might be said of most prime lenders who also allow borrowers to finance costs.

[22] It should be remembered that when effective prohibitions are added to prevent loan flipping, "equity stripping" becomes much less of a problem. Borrowers will not be repeatedly refinancing their loans in a short time period so they will not be repeatedly using equity to pay loan closing costs.

closing costs.[23] They are not required to finance their closing costs, but borrowers choose to do so in most cases because they determine that it is in their interest. (Many prime borrowers also choose to finance their closing costs.) Lenders have found that borrowers prefer paying these costs over the term of the mortgage. They want and need lower monthly payments. Having a higher rate with closing costs included as some have suggested would mean higher monthly payments, making mortgage credit much less affordable.

We support requiring a disclosure that financing points and fees is optional as is done in H.R. 833. However, CFAL believes that most legislators will agree that borrowers, both prime and nonprime, should continue to have the right to finance their loan closing costs. At most, some reasonable limitation on the amount of such costs that could be financed (e.g. at least 5%, depending on what is included in the costs definition) might be considered.

- **Mandatory Arbitration** – Many lenders include a clause in the loan terms that any disputes between the borrower and lender must be settled by a mandatory arbitration procedure instead of by court litigation. Consumer groups generally claim that mandatory arbitration clauses are inherently oppressive and deny borrowers their legal rights. They argue that arbitration is unfair and likely to favor the lender over the borrower. Lenders counter by noting that Congress has clearly indicated that arbitration is an acceptable alternative dispute resolution process. They say that arbitration is fair to both parties, and point out that it usually is much quicker and less expensive for borrowers. In addition, lenders point out that mandatory arbitration is allowed and often required in many other types of consumer financial transactions (e.g., real estate sales; securities; credit cards). Lenders also acknowledge that they favor using arbitration to resolve disputes because this approach helps facilitate settlements and prevents costly class action lawsuits.

CFAL does not believe that requiring arbitration is inherently unfair, but we do support imposing certain further statutory restrictions on arbitration clauses to ensure greater fairness to borrowers. In this regard, we think that the so-called "New York rule" (based on that state's law) is a reasonable solution. This rule, which is essentially contained in H.R. 833, would only allow arbitration clauses which require that: (1) the arbitration be conducted in accordance with the

[23] There are basically four options facing the consumer: (1) if their credit is adequate, and assuming no prohibition on "indirect" financing is applicable as it is in NJ, they can borrow the cash needed for closing elsewhere---typically at higher cost, unsecured rates *(e.g., a cash advance at a 19.99% APR via an AARP-sponsored credit card)*---and usually have much higher total monthly payments; (2) if they can afford it---and most can not---they can pay a higher rate with higher monthly payments as some consumer groups are advocating; (3) they can not get the loan and not be able to use their home equity to meet their financial needs, and possibly be forced into bankruptcy and/or foreclosure; or (4) they can sell their house and get their needed cash from their home equity.

standards set forth by a recognized national arbitration association; (2) it must be held in the federal judicial district where the loan property is located; and (3) the lender must pay all reasonable costs of the first 2 days of the arbitration.

- **Rulemaking for Additional Prohibitions** – Although this should not be a contentious issue, we want to recommend that the Committee ensure that there is an effective administrative procedure in place so that new prohibitions or further refinements can be added as may be needed based on subsequent experience and circumstances. It is highly likely that unscrupulous actors will find creative new ways to take unfair advantage of borrowers. Therefore, we believe that regulators should be able to move promptly to stop such practices without having to wait for new legislative authority. The Committee should consider whether the existing Federal Reserve Board rulemaking authority is adequate, or whether a different approach is needed.

LIABILITY & PENALTIES-RELATED ISSUES

- **Meaningful Right to Cure** – One of HOEPA's biggest flaws is its failure to provide a meaningful right to cure unintentional mistakes. CFAL believes that it is absolutely essential that such a right be provided for in any amendments. We recommend that lenders be given at least 90 days to correct an error after they learn of it either through their own actions or from the borrower or other persons such as a regulatory audit. Correction should entail whatever is required to make the borrower whole, including full restitution and payment for any loss or actual damages caused by the error. This right to cure should not apply, however, if the violation is considered willful or intentional.

- **Penalties** – Consumer groups have repeatedly sought to have state and local legislators adopt very onerous penalties for violations of "anti-predatory lending" laws. Also, consumer advocates have sought to allow "predatory lending" claims to be raised as defenses in every foreclosure action.

  We believe that many of the penalties advocated by consumer groups are excessive and unfair. In fact, having extremely severe penalties is one of the reasons that many lenders have been reluctant or even unwilling to continue making loans in Georgia earlier and as we are starting to see now in New Jersey and elsewhere. When onerous or unclear requirements are coupled with excessive penalties, the legal risks rise to unacceptable levels. Not only does this tend to limit credit availability, but it also causes higher prices for borrowers to offset the undue legal risks. We also are understandably concerned that legitimate foreclosure proceedings will be stymied by an open-ended provision allowing "predatory lending" claims to be raised in every foreclosure proceeding.

CFAL's members will support strong penalties, but we do ask that all penalties be graduated or proportional to the harm done, as well as to whether the violation was willful or intentional. Very tough monetary penalties should apply to willful violators who are the truly "bad actors". We would welcome the opportunity to work on a bipartisan basis with legislators to develop balanced, proportional penalty provisions.

- **Assignee Liability** – Consumer advocates have contended that traditional "holder in due course" type protection should be ended and that all assignees of nonprime loans should be strictly liable for any violations that occurred before the assignee obtained the loan even if the assignee had no knowledge of, or even could not reasonably have known of, the violation. These advocates contend that the secondary market is providing the funding for predatory loans, and that strict assignee liability is needed to cut off such funding. They maintain that such liability will force secondary market purchasers[24] to better police those from whom they buy loans.

Nonprime lenders and secondary market purchasers are strongly opposed to extending such strict liability to all nonprime loans.[25] We question whether it is appropriate to impose any liability on assignees, other than perhaps larger lenders who buy loans from smaller correspondent lenders. Today, only larger lenders with substantial resources are able to securitize loans. They clearly have the resources to ensure the borrower receives a full recovery of any damages. Moreover, they are in the best position to police the practices of their brokers, loan officers and correspondents.

The North Carolina law, which consumer advocates tout, does not include such strict assignee liability provisions. In contrast, imposing broad assignee liability in Georgia resulted in secondary market purchasers refusing to buy loans and loan rating agencies like Standard & Poor's and Moody's being unable to rate loans. This resulted in Georgia's nonprime lending market being shut down, and Georgia's legislature taking emergency action to address this unintended

[24] They typically do not mention that such purchasers include pension funds and other bond buyers who will be very reluctant, and most often unwilling to continue making capital available for mortgage loans if such liability is imposed.

[25] As I observed earlier, HOEPA currently applies such liability to "high cost" loans and that this is a major reason that most lenders do not make such loans. (HOEPA's assignee liability is so broad that it essentially makes the assignee liable for any violation of any law committed by the originator, even if the violation is not a violation of HOEPA.) Currently, virtually no private secondary market purchasers, including Fannie Mae and Freddie Mac, will buy such "high cost" loans. The relatively few such loans that exist appear to be ones made by retail lenders who keep them in their own portfolios. The cost of such loans, when available, also is generally significantly higher for the borrower not because of their credit risk, but because of the higher legal risk and reduced competition caused by the law. This is one of the perverse effects of the current statute.

consequence of its earlier legislative actions. New Jersey, Los Angeles and Oakland are now poised to have similar experiences for the same reasons.

Legislators must be extremely cautious in making changes that upset secondary market dynamics because unfettered access to the capital markets is largely responsible for having dramatically increased nonprime credit availability and for lowering costs for millions of Americans. Lenders and secondary market purchasers believe that it is very unfair to impose liability when there is no reasonable way that the loan or securities holder could have known of the violation. In any case, we feel that liability generally should apply only if the assignee by reasonable due diligence knew or should have known of a violation of the law based on what is evident on the face of the loan documents.

CFAL's members include many of the largest securitizers in the nonprime mortgage business. We again want to work closely with Committee members, as well as Wall Street investment bankers, the rating agencies, the GSEs and other key players in the securitization process to develop workable provisions on this liability issue so that mortgage capital.

SCOPE OF HOEPA'S COVERAGE

- **Expanding to Cover Other Types of Nonprime Loans** – At the present time HOEPA only applies to certain "closed-end" loans involving a refinancing of an existing mortgage. It does not cover either "open-end" loans, such as home equity lines of credit, or loans for the purchase of a home. A number of state measures have applied restrictions to such open-end and/or purchase money loans.[26] CFAL believes that it would be appropriate to expand the federal law so that its protections cover both of these types of loans. We feel that this is both proper policy and consistent with our support for uniform national lending standards for nonprime lending, which I will discuss further momentarily.

- **Expanding Coverage by Changing HOEPA's APR and "Points and Fees" Triggers** – As noted earlier, HOEPA currently only applies to a relatively small part of the nonprime market---i.e., certain of the highest cost loans where the APR or points and fees exceed specified threshold levels. Advocacy groups have consistently sought to extend coverage at both the federal and state levels by significantly lowering the trigger levels. We are unwilling to support such reductions unless HOEPA's current flaws are corrected <u>and</u> any new restrictions are truly balanced and workable. Our opposition is based on the very real concern that doing so would expose lenders and secondary market participants to unacceptable risk levels on far more loans. This would destroy large portions of the nonprime market, greatly limiting borrowers' credit access and increasing

[26] Please refer back to footnotes 13 and 14.

their costs. However, if HOEPA is restructured in a reasonable and fair manner, we are quite open to discussing expanding it to cover more nonprime loans.

UNIFORMITY & ENFORCEMENT-RELATED ISSUES

- **National Uniformity and Enforcement** – The irrational patchwork of state and local "anti-predatory lending" laws that is developing is not workable. None of these laws is the same, and requirements vary greatly. Provisions are often arbitrary, unclear and totally impractical for lenders to implement. Well intended, but poorly crafted state and local requirements are having unintended negative consequences for borrowers. Most states also still have no effective borrower safeguards in place.

  Today, nonprime lending is clearly a nationwide, interstate business that is highly dependent on the national capital markets in order to make affordable mortgages available to the millions of Americans who can not qualify for conventional financing. We need consistent, nationwide requirements to be able to do so effectively and efficiently. Borrowers need protections not only from abusive lending practices, but also from differing, poorly crafted state and local laws that limit their access to affordable credit and force them to pay more.

  CFAL therefore strongly supports prompt Congressional action to provide clear, effective and workable uniform national fair lending standards[27] for nonprime mortgage loans. These standards should provide equal protections for all Americans and apply to all mortgage originators, regardless of how they may be structured or chartered.

  We also believe that state officials should have an active role along with federal authorities in enforcing these national standards.

OTHER RELATED ISSUES

In closing, I want to mention that we also want to work with Committee members and other interested parties on various other related issues that are likely to come up in this debate---such as expanding consumer financial education and counseling opportunities; mortgage broker licensing requirements; loan servicing; and preventing "property flipping". In particular, CFAL is especially interested in pursuing proposals, such as Rep. Scott and others have offered, relating to borrower education which can empower people to make more informed financial choices and to avoid abusive practices. The long term answer to many of these problems is education, not restrictive legislation. Among other things, we think

[27] Both Fannie Mae and Freddie Mac also have now expressed their support for uniform national standards, as have many other lenders and trade groups.

that the Committee might want to consider having nonprime lenders pay a reasonable fee into a central fund when they originate a mortgage. This fee could be used as a funding mechanism for state and community based education programs and quite possibly for state enforcement efforts.

* * *

CFAL is confident that Congress can fairly resolve these issues and pass effective national standards for fair lending that protect nonprime borrowers without unduly limiting their access to affordable mortgage credit. We look forward to working constructively with Committee members and all other interested parties to help enact such legislation.[28]

[28] *Please feel free to contact me, or CFAL's Executive Director, Wright H. Andrews (202-742-4245, wandrews@butera-andrews.com), if you have questions or would like further information about CFAL's positions.*

National Association of Mortgage Brokers

Prepared Testimony of A.W. Pickel, III,

President of the

National Association of Mortgage Brokers

on

"Protecting Homeowners: Preventing Abusive Lending

While Preserving Access to Credit"

before the

Subcommittee on Housing and Community Opportunity and the Subcommittee on Financial Institutions and Consumer Credit

Committee on Financial Services

U.S. House of Representatives

Wednesday, November 5, 2003 RHOB 2128

Good morning Chairman Bachus, Chairman Ney, and members of the committee. My name is A.W. Pickel, III, President of the National Association of Mortgage Brokers (NAMB) and President of Leader Mortgage Company in Lenexa, Kansas. Thank you for inviting NAMB to testify today on the very vital issues pertaining to the prevention of abusive lending practices, preserving access to consumer credit and protecting homeowners in America.

I want to commend both of you for your leadership on this issue, as NAMB believes that vetting the issues relative to abusive lending practices is the key to prevention and the disgorgement of abusive lending tactics. I also want to thank you for including NAMB in the series of predatory lending roundtable discussions you have held over the past few months. We appreciate your continued efforts to provide a forum in which interested parties can discuss these issues in an effort to protect consumers.

NAMB is the nation's largest organization exclusively representing the interests of the mortgage brokerage industry and has more than 16,000 members and 46 state affiliates. We represent mortgage brokers in all 50 states and in the District of Columbia. NAMB believes that abusive lending practices committed by anyone or any entity hurt consumers and adversely affect the reputation and public perception of all mortgage industry participants. We support efforts to expose abusive lending practices and combat abusive tactics provided that these efforts do not inadvertently cut off credit access to consumers or inhibit the ability of the mortgage finance industry to continue to work with consumers through the homebuying process.

With the homeownership rates rising in America to 68.4% in the third quarter,[1] it is imperative that consumers trust in the integrity of those in the mortgage industry so that the homeownership rate will continue to rise and consumers will continue to experience the joys of homeownership. While many factors have contributed to this record increase in homeownership, one of the principal factors has been the rise of wholesale lending through mortgage brokers. Today, mortgage brokers originate two out of every three mortgage loans. In 2002, there were 44,000 mortgage brokerage companies that employed an estimated 360,000 people. Since mortgage brokers represent 65% of the home loans originated in 2002, it is not surprising that mortgage brokers originate more mortgages than any other single loan source group in this nation.

THE ROLE OF MORTGAGE BROKERS

A mortgage broker is an independent real estate financing professional who specializes in the origination of residential and/or commercial mortgages. A mortgage broker is also an independent contractor who markets and originates loans offered by multiple wholesale lenders. We can offer consumers superior expertise and assistance in getting through what can be a very tedious and complicated loan process.

Mortgage brokers serve a very significant role to the consumer throughout the mortgage process. They spend a significant amount of time with mortgage applicants, working through credit problems with them, assisting those having no credit histories, and helping them finance the purchase of their home. Before a consumer applies for a mortgage loan, mortgage brokers often work with these consumers to help them review and correctly dispute their credit when necessary.

A mortgage broker does not simply press a few keys to provide the consumer with a mortgage loan. Nor are mortgage loans akin to products that can be picked from a shelf and paid for at checkout. Mortgage brokers perform a vital and unique role in assisting consumers in obtaining a mortgage loan.

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[1] U.S. Census Bureau, third quarter, 2003.

THE ROLE OF MORTGAGE BROKERS IN COMBATING ABUSIVE LENDING

NAMB is committed to preventing abusive lending practices from destroying the dream of homeownership for American families. We recognize that there are families that have suffered because of abusive lending practices, and we deplore these practices. Abusive lending practices strip borrowers of home equity and threaten families with foreclosure, destabilizing the very communities that are beginning to enjoy the fruits of our nation's economic success. The vast majority of mortgage lenders and mortgage brokers are honest and provide services to their customers with integrity. If consumers did not feel mortgage brokers were delivering on what was promised, they would not reward them in the market. As every industry has some bad actors, NAMB wants to weed out these unscrupulous actors so that they cannot prey on vulnerable homeowners. NAMB believes abusive lenders should not be tolerated in our industry or in any other industry.

NAMB believes that industry self-regulation can play an integral role in efforts to combat abusive lending practices. As we recognize, buying or financing a home is one of the largest, most complicated and vitally important decisions facing consumers in this country. We believe that an informed and educated consumer is better off during the home buying process, however, we also believe it is essential that residential mortgage loan originators who work directly with these homebuyers are educated, honest, and nothing short of professional.

Before residential loan originators deal with a potential or current homeowner, they must have formal training, and should be tested on their knowledge of matters including financial analysis, ethics, federal and state disclosures, real estate law, and mathematical computations germane to real estate and mortgage lending.

As such, in 2002, NAMB introduced its Model State Statute Initiative (MSSI) on licensing, pre-licensure education and continuing education requirements to protect consumers and ensure originator competency. Through MSSI, NAMB seeks to have individual state statutes enacted that require pre-licensure education and mandate continuing education requirements for all residential loan originators. This model statute would serve as a model for state regulators and legislators whose states do not have such statutes or whose states need to improve their statues to protect and better serve the community. NAMB believes that such an initiative will serve to help reduce the incidence of abusive lending practices and improve the overall competency of the industry.

NAMB is also leading an industry effort to create a nationwide registry of mortgage originators and companies. NAMB supports a federal registry of all loan originators. We believe a nationwide registry will give mortgage industry professionals an avenue to report unscrupulous actions by other mortgage professionals, and help to police itself and eliminate bad actors from its ranks.

In addition, NAMB believes it is imperative for consumers and for the integrity of the profession that its members adhere to a set of best practices. Last year, NAMB participated in the Predatory Lending Roundtable sponsored by federal regulators, whereby we discussed the merits of developing a national code of best practices to address predatory lending. As a requirement of NAMB membership, all members and their employees subscribe to the "Best Lending Practices Guidelines." [2] We encourage homebuyers to look for adherence to these guidelines as important selection criteria when choosing a mortgage broker.

Furthermore, members of NAMB must also adhere to the Code of Ethics of NAMB and of their affiliated state associations, reflecting professionalism, honesty, and integrity among brokers.[3] Finally, NAMB has implemented a Model Loan Origination Agreement in an effort to help inform consumers about the role of the mortgage broker and how a broker is compensated. [4]

DEFINING THE PROBLEM

Abusive lending practices occur in all areas of mortgage lending, although most attention today has been given to those practices taking place in the subprime market. Although we believe the incidence of abuse is very small relative to the whole industry, we believe that any abuse committed against consumers is too much. Some of the barriers to fair lending include addressing the complexity of the mortgage process and the insufficient enforcement of existing laws.

The mortgage process can be a difficult experience for consumers. Mortgage brokers spend a significant amount of time with consumers to help them understand the complicated mortgage process. They talk with consumers and walk them through the many facets of purchasing a home so that the consumer has a better understanding of each step of the process and is comfortable. NAMB has long supported the reform of mortgage laws and has participated in broad industry initiatives to facilitate comprehensive mortgage reform. We believe any proposal to reform the current mortgage laws should enhance consumer choice, clarify the process, and enable small businesses to continue to engage with consumers in mortgage transactions.

NAMB believes existing laws should be better enforced by state and federal regulators as a means to eliminate a great deal of abusive lending practices. Federal fair lending and consumer protection laws, such as the Fair Housing Act, the Equal Credit Opportunity Act, the Truth in Lending Act as amended by the Home Ownership and Equity Protection Act (HOEPA), and the Real Estate Settlement Procedures Act all provide substantive protection to borrowers. These laws provide disclosure requirements, define high cost loans, and contain anti-discrimination provisions. Many of the abusive lending practices that are taking place often involve outright fraud, in addition to misleading and deceptive sales and marketing practices, which are already illegal. Although the mortgage lending industry is heavily regulated through these laws, the perpetrators often ignore these laws and go unpunished for their violations.

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[2] Attachment 1, NAMB, Best Lending Practices Guidelines.
[3] Attachment 2, NAMB, Code of Ethics.
[4] Attachment 3, NAMB, Model Loan Origination Agreement.

There is a serious lack of enforcement of these laws. This current lack of enforcement creates an environment whereby abusive lenders continue to cultivate, from which consumers will suffer the consequences.

Many current state and federal proposals to address abusive lending practices would not necessarily prevent abusive lending practices, but could in fact, be harmful to consumers by restricting their choices of loan products and terms. Many of these laws only add to restrictions on law-abiding legitimate originators, while doing nothing to stop the truly unscrupulous lenders who will simply ignore the new law.

SUBPRIME LENDING

There has been widespread confusion as to the terms "subprime" and "predatory" as many reports of unfair lending are alleged to have come from subprime loans. Conventional borrowers, however, can also experience abusive lending practices. Although numerous state and federal laws regulate mortgage lending, these laws and regulations do not define predatory lending. Abusive lending often involves certain products that are used improperly through unfair marketing tactics, collection practices, and loan terms that, when combined, deceive and exploit borrowers.

Subprime lending on the other hand, is usually linked to the credit status of the borrower. That is, subprime lending often serves the market of borrowers whose credit history would not permit them to qualify for the conventional "prime" loan market.

Subprime loans are inherently riskier than loans made in the prime market. Generally, the risk associated with subprime loans can be attributed to borrowers' tarnished credit records or uncertain income prospects. Subprime loans naturally feature pricing and other contract terms that either compensate for or are intended to lessen some of these risks.

To a great degree, the rapid growth in subprime lending has been fueled by technological changes. The most prominent of these changes has been the widespread use of credit scoring models that permit lenders to determine efficiently and quickly the appropriate pricing for a subprime loan. Prior to the advent of these tools, the loan application most likely would have simply been denied. Despite the growth of subprime lending, it should be remembered that such loans still represent only a small portion of the overall mortgage market.

The great majority of subprime lending today results in benefits to consumers at reasonable, appropriate risk-based prices. Consumers with blemished credit that do not qualify for conventional, "prime" market loans still deserve the opportunity to obtain credit and experience homeownership. Subprime lending has expanded affordable credit for many consumers who otherwise would have no other option to obtain credit. It is imperative that any proposal to address abusive lending is carefully considered as to not restrict these consumers from credit.

ADDRESSING THE PROBLEM

Many proposals have been introduced on the state and local level in an effort to provide consumer protection against abusive lending practices in connection with mortgage loans. Some proposals ban such practices as balloon payments and prepayment penalties while others prohibit the charging and/or financing of certain fees. While well-intended, outright prohibitions of such practices could unduly limit credit availability or increase the cost of credit to the same consumers that we are trying to protect. For example, a loan amortized over 30 years with a balloon payment due after 5 years is a valuable tool to help a borrower obtain a lower interest rate and lower monthly payments while at the same time giving the borrower time to repair his/her credit. Many reputable, mainstream lenders offer balloon loans to consumers in all credit grades, because they are good options for consumers in many cases.

The same is true for other loan terms or conditions frequently cited as abusive, including negative amortization, prepayment penalties, financing of closing costs, and even arbitration clauses. In certain circumstances, each of these may be abusive, but in many cases they provide the consumer with a feature that fits his or her unique circumstances, such as a reduced interest rate or lower monthly payment.

Whether a loan is abusive is a question that turns on the context and circumstances, from case to case. For example, a balloon term in a given loan could be abusive if the borrower has not been advised that the loan contains such a feature and is not prepared for the practical ramifications. Further, it may be that the borrower's situation does not make such a feature appropriate. These types of abusive lending tactics cannot be tolerated.

We strongly believe that one cannot define any loan as "predatory" or abusive based simply on the rate, points, or fees involved, or because the loan includes a feature such as a balloon, a prepayment penalty, negative amortization, or financing of closing costs. Rather, the abuse comes from the lender fraudulently deceiving the consumer by providing misleading or inaccurate disclosures, failing to accurately describe the loan terms, unfairly pressuring the consumer to take a loan, and/or failing to highlight the consumer's right of rescission. In many of these cases, the consumer has also failed to fully understand the terms and details of the loan or shop for a better deal, which is why consumer financial education is a necessity.

CONSUMER EDUCATION

The Department of Housing and Urban Development (HUD) Secretary Mel Martinez put the issue of education in focus when he said, "Education is key. Studies show that consumers who understand the home-buying process are more likely to buy a home they are happy with and less likely to be taken in by predatory lenders." [5]

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[5] Department of Housing and Urban Development, "Blueprint For the American Dream," September 24, 2002.

A major tool to combat abusive lending practices is to improve consumer awareness through education. Informed consumers are in a better position to protect themselves from abusive lending practices. Certainly, it is imperative that the industry reach out to the people most frequently targeted by predatory lenders - low- and moderate-income households, the elderly and underserved communities in urban and rural areas.

NAMB strongly advocates that our members never originate a loan to an uninformed consumer. Since mortgage brokers originate more than 65% of homes, we believe that we are in a unique position to provide education about homeownership to consumers. We support the efforts by President George W. Bush to promote education, including the education of owning a home and the education of buying a home throughout our society.[6] Earlier this year, NAMB engaged in a commitment for a new consumer education program, *"Are You Prepared to Head Down the Road to Home Ownership?"*[7] in an effort to promote homeownership to potential homebuyers from inner city and urban populations. The program provides potential homebuyers with basic information to help them make informed choices when buying a home and to avoid abusive lending practices. This program was developed to answer President Bush's call through the Blueprint for the American Dream to help close the minority homeownership gap in America. In the one-hour presentation, a mortgage broker explains to consumers industry terminology, highlights the home buying process, including what the process entails, explains the credit check process, and goes over the expenses associated with homeownership.

NAMB's website includes extensive consumer information and links to sites that provide consumers a wealth of information they can use to make informed mortgage choices. The NAMB Mortgage 101 Center provides consumers with information from one of the mortgage industry's most popular and reliable online resources. The website provides consumers with information, in an unbiased manner, about completing applications, the purpose of an appraisal, bankruptcy and its alternatives, mortgage calculators, down payments, FHA loans, loan programs, refinancing, relocation, second mortgages, VA loans and many other topics.

NAMB supports industry efforts to educate homebuyers on selecting a good-quality mortgage loan and efforts to educate consumers on how to avoid being a victim of abusive lending tactics. Fannie Mae, with its "Consumer Bill of Rights" campaign and Freddie Mac with its "Don't Borrow Trouble" campaign are putting millions of dollars into educating people about how to choose a good mortgage loan and avoid being victims of abusive lending practices. We also commend HUD for its recent introduction of a new education piece for consumers, "Don't Be a Victim of Loan Fraud – Protect Yourself from Predatory Lenders," which educates consumers on how to avoid becoming victims of predatory lending. HUD's pamphlet describes nine different types of predatory lending, offers 11 tips on being a smart consumer and describes seven tactics commonly used by predatory lenders in an effort to help consumers avoid loan fraud.

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[6] Remarks by President George W. Bush, St. Paul AME Church Atlanta, Georgia, June 17, 2002.
[7] Attachment 4, NAMB, "Homeownership Education: Where the American Dream Becomes Reality."

It is also essential for consumers to understand how to use credit, and the significant impact their credit has on their ability to obtain a mortgage at the lowest cost. NAMB supports efforts to educate consumers on broader financial issues, such as managing money, managing credit card debt, and other important issues. Ideally, these areas should be taught routinely as part of the standard junior high school or high school curricula in schools. Last year, the President signed the "No Child Left Behind Act," which included a new program to promote economic and financial literacy among students from kindergarten through grade 12 through teacher training, research, assessment, dissemination of best practices, and partnerships between private and public entities at the national, state, and local levels through a grant process. Educating consumers in economics and personal finance in every stage of life, beginning in the younger years, is vital to our nation's future. Indeed, it is an essential key to building a nation of knowledgeable investors and savers, informed and responsible consumers, productive members of the workforce and effective participants in the nation's economy.

NAMB supports pending federal legislation that includes provisions to address financial literacy. Such provisions are included in the House and Senate Fair Credit Reporting Act/identity theft legislation. The House legislation includes a provision directing the General Accounting Office to conduct a study on the need and the means for improving financial literacy among consumers, including consumer knowledge of credit reports, credit scores, the credit dispute resolution process, and methods for improving financial literacy. The Senate legislation includes a provision that calls for the creation of a Financial Literacy and Education Commission to develop a national strategy to promote financial literacy and education for consumers. In an effort to improve financial literacy and education, the newly established Commission shall emphasize, among other elements, basic personal income and household money management and planning skills, including how to avoid abusive, predatory, or deceptive credit offers and financial products. These financial literacy provisions are important steps and can be used as valuable tools to help educate consumers in preparation of purchasing a home.

PREEMPTION

The passage of state laws and ordinances by cities has also resulted in concerns about the difficulties lenders face in attempting to comply with a patchwork of state and local laws. NAMB is increasingly concerned about the proliferation of state and local initiatives that purport to address predatory lending. Mortgage lending has become largely a nationwide industry, with a number of lenders operating in all 50 states. It will be incredibly burdensome and confusing to lenders if they have to begin complying with 50 different state and local lending restrictions, a result from which consumers will ultimately suffer. Overreaching state and local laws will only disrupt the market, preventing lenders from offering borrowers legitimate nonprime products, and increasing loan costs for consumers. We believe the record levels of homeownership in the United States can be attributed to the vibrant and competitive mortgage market. The importance of preemption can be seen in the recent actions of the federal financial regulators in enacting swift state law preemption directives. A level playing field for all market participants is needed to keep the flow of capital to the mortgage market, enabling competition to keep market players and rates in check and allowing consumers to have continued access to credit.

CONCLUSION

We are deeply troubled by the continued reports of abusive lending practices in the mortgage industry Consumers should not have their dream of homeownership ruined by unscrupulous players in the mortgage industry. It is, however, important to emphasize that addressing abusive lending requires a balanced response and being cognizant of the complex national system of financing in this country that is the envy of the world. NAMB urges increased enforcement of existing abusive lending prevention laws, enhanced consumer education and simplification of the mortgage process, and industry self-regulation as key tools to address predatory lending issues.

Any efforts to address abusive lending practices cannot cut off access to consumer credit. Subprime lending has many desirable benefits, and we would not want to adopt draconian policies that extinguish or greatly curtail legitimate subprime business. At the same time, we must remain alert to the potential for abuse. Combating abuse calls for a comprehensive, multi-dimensional strategy, and one that employs the most effective tools available to the regulatory, legal, and educational communities. It is the duty of all participants in the mortgage community to maintain the integrity of our credit systems, and to thwart participants that do not honor these systems.

Thank you for giving me the opportunity to testify this morning. I would be happy answer any questions you may have.

Attachment 1

BEST LENDING PRACTICES GUIDELINES

[name], a member of the National Association of Mortgage Brokers, and [job title and company name], a properly licensed/authorized entity, adheres to the Code of Ethics of NAMB and of my affiliated state association. Furthermore, as a requirement of NAMB membership, I hereby subscribe [company name] and its employees to the following "Best Lending Practices Guidelines." We will...

- Disclose accurate information in all solicitations and advertising;
- Discuss and explain financing program options;
- Inform you, in writing, of lock-in options;
- Explain all documents of the loan application;
- Explain all associated costs of the loan application;
- Explain the disbursement of all loan applications;
- Explain the loan process, from application to closing;
- Charge only those fees which are disclosed or re-disclosed on your good faith estimate;
- Charge rates and fees that do not vary based on race, color, religion, natural origin, gender, marital status, age, receipt of income from public assistance programs, or good faith exercise of rights under consumer finance laws;
- Communicate with you throughout the loan process in a timely manner;
- Commit to be your financing resource before, during, and after your transaction.

Attachment 2

NAMB CODE OF ETHICS

The members of the National Association of Mortgage Brokers, believing that the interests of the public and private sector are best served through the voluntary observance of ethical standards of practice, hereby subscribe to the following Code of Ethics.

HONESTY & INTEGRITY
NAMB members shall conduct business in a manner reflecting honesty, honor, and integrity.

PROFESSIONAL CONDUCT
NAMB members shall conduct their business activities in a professional manner.

HONESTY IN ADVERTISING
NAMB members shall endeavor to be accurate in all advertisements and solicitations.

CONFIDENTIALITY
NAMB members shall avoid unauthorized disclosure of confidential information.

COMPLIANCE WITH LAW
NAMB members shall conduct their business in compliance with all applicable laws and regulations.

DISCLOSURE OF FINANCIAL INTERESTS
NAMB members shall disclose any equity or financial interest they may have in the collateral being offered to secure a loan.

Attachment 3

NAMB MODEL MORTGAGE LOAN ORIGINATION AGREEMENT

(MUST BE ADAPTED TO CONFORM TO APPLICABLE STATE LAW)

You, the applicant(s), agree to enter into this Mortgage Loan Origination Agreement with (Name of Company) as an independent contractor to apply for a residential mortgage loan from a participating lender with which we from time to time contract upon such terms and conditions as you may request or a lender may require. You inquired into mortgage financing with (Name of Company) on _________(date). We are licensed as a "Mortgage Broker" under (Name of Law).

SECTION 1. NATURE OF RELATIONSHIP

In connection with this mortgage loan we are acting as an independent contractor and not as your agent. We will enter into separate independent contractor agreements with various lenders. While we seek to assist you in meeting your financial needs, we do not distribute the products of all lenders or investors in the market and cannot guarantee the lowest price or best terms available in the market.

SECTION 2. OUR COMPENSATION

The lenders whose loan products we distribute generally provide their loan products to us at a wholesale rate. The retail price we offer you--your interest rate, total points and fees--will include our compensation. In some cases, we may be paid all of our compensation by either you or the lender. Alternatively, we may be paid a portion of our compensation by both you and the lender. For example, in some cases, if you would rather pay a lower interest rate, you may pay higher up-front points and fees. Also, in some cases, if you would rather pay less up-front, you may be able to pay some or all of our compensation indirectly through a higher interest rate in which case we will be paid directly by the lender. We also may be paid by the lender based on (i) the value of the Mortgage Loan or related servicing rights in the market place or (ii) other services, goods or facilities performed or provided by us to the lender.

By signing below, applicant(s) acknowledge receipt of a copy of this signed Agreement.

MORTGAGE LOAN ORIGINATOR

By:________________________

Name:______________________

Date:________________________

Address:

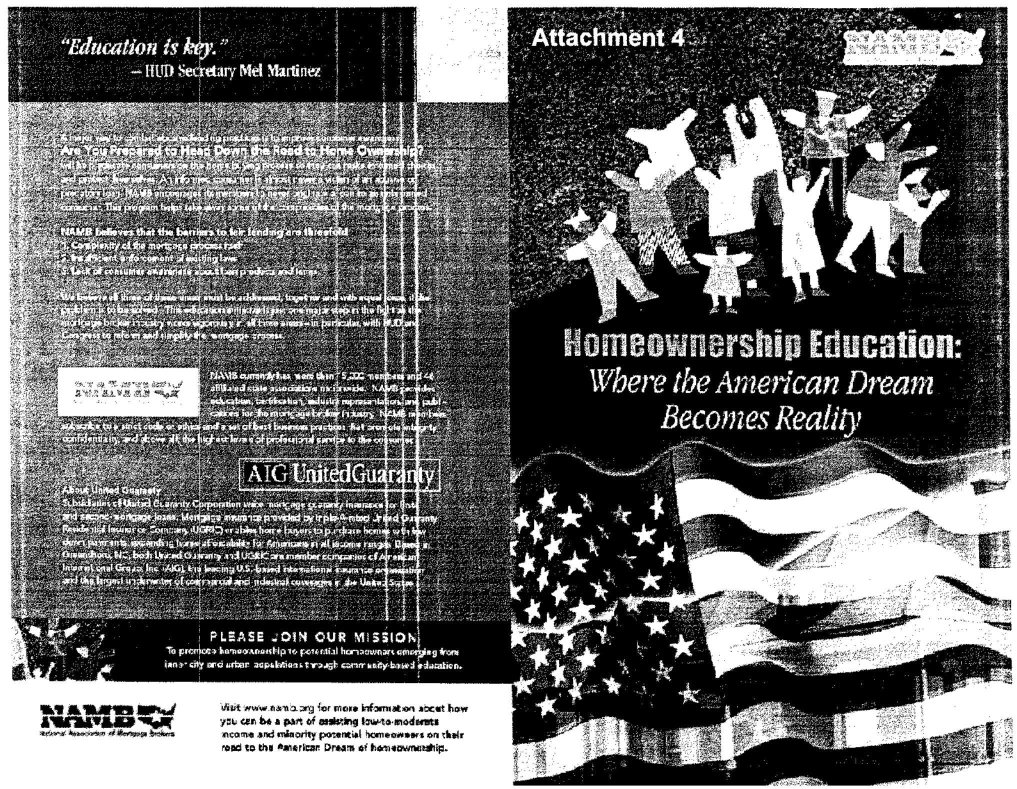
APPLICANT(S)

By:______________________

Name:______________________

Date:__________________________

Address:


Attachment 4
Homeownership Education:
Where the American Dream
Becomes Reality
"Education is key."
– HUD Secretary Mel Martinez
Are You Prepared to Head Down the Road to Home Ownership?
NAMB believes that the barriers to fair lending are threefold
AIG UnitedGuaranty
About United Guaranty
PLEASE JOIN OUR MISSION
To promote homeownership to potential homeowners emerging from inner city and urban populations through community-based education.
Visit www.namb.org for more information about how you can be a part of assisting low-to-moderate income and minority potential homeowners on their road to the American Dream of homeownership.
NAMB
National Association of Mortgage Brokers

PLEASE JOIN OUR MISSION

To promote homeownership to potential homeowners emerging from inner city and urban populations through community-based education.

"One of the things we are going to do is we're going to promote education, the education of owning a home, the education of buying a home throughout our society."

— President George W. Bush, June 17, 2002

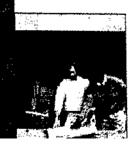
The National Association of Mortgage Brokers (NAMB) has partnered with United Guaranty (UG) in a commitment through 2010 to increase home financing education to minorities, immigrants, and low-to-moderate income borrowers.

This partnership was formed to answer President Bush's call through Blueprint for the American Dream to help close the homeownership gap in America.

Our nation enjoys an all-time record rate of homeownership, but more needs to be done to help minority and low-to-moderate income borrowers obtain the American Dream of homeownership. While many factors have contributed to this record of success, one of the principal factors has been the rise of wholesale lending through mortgage brokers. This is why mortgage brokers, who originate more than 55% of all home loans, are the perfect vehicle to provide grassroots education about the facts of homeownership to those individuals and communities who need it most.

NAMB and UG have identified target markets and are diligently working with local government officials and minority community leaders to bring Are You Prepared to Head Down the Road to Home Ownership? to their constituencies. Please pledge your support of this program and work with your local NAMB state affiliate to bring this crucial education to your communities.

Visit www.namb.org for more information about how you can be a part of assisting low-to-moderate income and minority potential homeowners on their road to the American Dream of homeownership.



About Our Education Program

The new consumer education program: **Are You Prepared to Head Down the Road to Home Ownership?** created by the National Association of Mortgage Brokers (NAMB) and United Guaranty (UG) is a consumer information seminar designed to provide minority, immigrant and low-to-moderate income potential homebuyers with basic information to help them make informed choices when buying a home – and to avoid abusive lending practices.

The seminar includes:

- The pros and cons of buying a home
- Maintenance costs involved with homeownership
- Tracking spending habits and analyzing personal finances
- Understanding the importance of a credit history
- Overview of fair housing laws
- The do's and don'ts for new homeowners
- Answers to common questions

With an increasing number of potential homeowners emerging from inner city and urban populations, mortgage brokers are assisting more and more individuals from diverse cultures who have different needs and approaches to the home buying process and homeownership.

Unfortunately, **many barriers to homeownership do exist** for these populations. A significant issue is that many feel they can't do it – that they can't afford it or get the help they need to make homeownership a reality for their family. This program provides hope and information for those who are in the position to become first-time homebuyers, and assists those who aren't ready yet with more training and assistance to ensure future homeownership.

NAMB member brokers are trained to present this course in their communities to break down these and other barriers for minority and low-to-moderate income potential homeowners.

TESTIMONY OF FRANK RAITER
MANAGING DIRECTOR
STANDARD & POOR'S CREDIT MARKET SERVICES

SUBMITTED TO THE SUBCOMMITTEE ON HOUSING AND COMMUNITY OPPORTUNITY AND THE SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT
U.S. HOUSE OF REPRESENTATIVES

HEARING ON: PROTECTING HOMEOWNERS: PREVENTING ABUSIVE LENDING WHILE PRESERVING ACCESS TO CREDIT

NOVEMBER 5, 2003

Standard & Poor's Ratings Services ("Standard & Poor's"), part of Standard & Poor's, a division of The McGraw-Hill Companies, Inc. ("McGraw-Hill"), appreciates the opportunity to share its views on its approach to rating securities backed by loans governed by anti-predatory lending statutes. As an independent and objective commentator on credit risk, Standard & Poor's generally does not take a position on questions of public policy. Thus, while Standard & Poor's strongly supports efforts to combat predatory lending and other abusive practices by lenders, it does not take a position on what legislative and regulatory actions would best accomplish that goal. Nevertheless, Standard & Poor's has been closely following legislative and regulatory initiatives designed to combat predatory lending in order to determine how those laws might affect its ability to rate securities backed by residential mortgage loans. Accordingly, Standard & Poor's is pleased to discuss the factors that it considers when evaluating the impact of anti-predatory lending laws on its rated transactions.

INTRODUCTION

Since beginning its credit rating activities in 1916, Standard & Poor's has rated hundreds of thousands of securities issues, corporate and governmental issuers and structured financings. Standard & Poor's began its ratings activities with the issuance of credit ratings on corporate and governmental debt issues. Responding to market developments and needs, Standard & Poor's also assesses the credit quality of, and assigns credit ratings to, financial guarantees, bank loans, private placements, mortgage- and asset-backed securities, mutual funds and the ability of insurance companies to pay claims, and assigns market risk ratings to managed funds.

Today, Standard & Poor's has credit ratings outstanding on approximately 150,000 securities issues of obligors in more than 50 countries. Standard & Poor's rates and monitors developments pertaining to these securities and obligors from operations in 20 countries around the world. With a U.S. staff of approximately 1,250 Standard & Poor's rates more than 99.2% of the debt obligations and preferred stock issues publicly traded in the United States.

Standard & Poor's believes that over the last century credit ratings have served the U.S. securities markets extremely well, providing an effective and objective tool in the market's evaluation and assessment of credit risk. Standard & Poor's recognizes the valuable role that credit rating agencies play in the U.S. securities markets and is committed to protecting and enhancing the reputation and future of its credit ratings business. In this regard, Standard & Poor's takes great care to assure that its credit ratings are viewed by the market as highly credible and relevant and will continue to review its practices, policies and procedures on an ongoing basis and modify or enhance them, as necessary, to ensure that integrity, independence, objectivity, transparency, credibility, and quality continue as fundamental premises of its operations.

When Standard & Poor's issues a rating, it is offering its opinion about a company's medium to long-term credit risk. Similarly, ratings on particular instruments, such as the securities related to structured finance transactions, reflect Standard & Poor's opinion about the likelihood of default on those securities. In determining all of its ratings, Standard & Poor's tries to take into account whatever relevant future events may be anticipated.

Standard & Poor's does not perform an audit of the issuer, does not guaranty an issuer's payment on its debt, or provide insurance in case the issuer does not pay the debt. A Standard & Poor's rating does not constitute a recommendation to purchase, sell, or hold a particular security. Nor does a Standard & Poor's rating speak to the suitability of an investment for particular investors. Rather, a rating reflects Standard & Poor's opinion as of a specific date of the creditworthiness of a particular company or security based on Standard & Poor's objective and independent analysis.

EVALUATING PREDATORY LENDING LAWS

General

Increased access to mortgage loans has led to increased home ownership across the U.S. While this growth in home ownership is positive, it has become evident that some of this increase has unfortunately occurred simultaneously with a rise in predatory lending practices. Among others, these predatory practices include the following: charging excessive interest or fees; making a loan to a borrower that is beyond the borrower's financial ability to repay; charging excessive prepayment penalties; encouraging a borrower to refinance a loan notwithstanding the lack of benefit to the borrower; and increasing interest rates upon default.

To protect borrowers from unfair, abusive, and deceptive lending practices, numerous state and local governmental bodies have enacted anti-predatory lending statutes. Typical statutes include provisions that:

- Limit the interest rates and fees that a lender may charge;
- Preclude lending to borrowers without regard to their ability to repay;
- Require refinance loans to provide a net tangible financial benefit to the borrower;
- Prohibit excessive prepayment penalties and balloon payments;
- Require disclosure to the borrower of various loan provisions; and
- Require counseling for borrowers who are planning to take out certain loans that are governed by these laws.

Anti-predatory lending statutes are designed to protect borrowers from such practices, and Standard & Poor's strongly supports efforts to combat predatory lending. For several reasons, however, these statutes may also have the negative effect of reducing the availability of funds to such borrowers. First, a lender might reduce its lending in a given state to protect itself from being found in violation of the state's anti-predatory lending statute. Second, a lender might reduce its business because the cost of lending in accordance with a statute's provisions might be uneconomical. Third, a lender might reduce its activities within a given state if the market for the sale of loans originated in that state is effectively eliminated. This would occur, for example, if an anti-predatory lending statute imposes liability on purchasers or assignees of loans causing potential purchasers and assignees to reduce, or even cease, their purchasing to avoid liability under the statute.

Moreover, and most importantly from Standard & Poor's perspective, an anti-predatory lending statute's imposition of liability on purchasers or assignees of mortgage loans ("assignee liability") might reduce the availability of funds to pay investors in securities backed by mortgage loans governed by the statute. This would occur if the purchaser or assignee were found to hold a loan that violated the statute ("predatory loan"), even if the purchaser or assignee did not itself engage in predatory lending practices. Therefore, in performing a credit analysis of structured transactions backed by residential mortgage loans, Standard & Poor's evaluates the impact an anti-predatory lending statute might have on the availability of funds to pay investors in the rated securities. To the extent that Standard & Poor's determines that investors in securities backed by loans governed by an anti-predatory lending statute might be negatively impacted, Standard & Poor's may require additional credit support to protect investors or, in certain circumstances, preclude such loans from being included in Standard & Poor's rated transactions.

Evaluation of Statutes

In performing its evaluation of anti-predatory lending statutes, Standard & Poor's considers, among other factors, whether the statute provides for the following: (i) assignee liability; (ii) clearly delineated loan categories; (iii) penalties, including monetary damages, as well as restrictions or prohibitions on doing business with the governmental entity whose legislation is at issue; and (iv) clarity of statutory violations and safe harbors.

1. *Assignee Liability*. As the first part of its analysis, Standard & Poor's will review an anti-predatory lending statute to see if it imposes assignee liability in connection with any

type of loan covered by the statute (a loan with associated assignee liability is referred to in this discussion as an "exposed loan"). Standard & Poor's defines assignee liability as liability that attaches to a purchaser or assignee of a loan (including a securitization trust) simply by virtue of holding a predatory loan. An anti-predatory lending statute may impose assignee liability in a direct action by the borrower or only defensively, i.e., in an action by the purchaser/assignee to enforce a loan. Typically, statutes that impose assignee liability permit a borrower to assert the same defenses against the purchaser or assignee as it could assert against the original lender.

If Standard & Poor's determines that no assignee liability is provided for under the statute, Standard & Poor's will, generally, permit loans covered by the statute to be included in Standard & Poor's rated transactions. If, on the other hand, Standard & Poor's determines that a given state's anti-predatory lending statute does permit assignee liability, Standard & Poor's will continue with the second part of its analysis.

2. *Statutory Loan Categories*. As the second part of its analysis, Standard & Poor's examines the categories of loans that are identified in the statute. Standard & Poor's considers whether the language of the statute clearly distinguishes between those loans that are covered by the statute and those that are not, as well as among the various loan categories (for example, covered, high cost) covered by the statute. Standard & Poor's looks to see if a loan originator, a seller of loans into a securitization transaction, or a purchaser or assignee of loans would be able to determine what category of loan (according to the statute) the entity is originating, selling, or purchasing.

If Standard & Poor's concludes that the distinctions discussed above are not clearly set forth in the statute, then Standard & Poor's may not be able to rate transactions that include any loans originated in the relevant jurisdiction.

If, however, Standard & Poor's determines that the distinctions discussed above are clearly set forth in the statute, Standard & Poor's will determine for which loan categories the statute provides assignee liability. In general, and consistent with its approach discussed above in section 1, Standard & Poor's will permit loans with no associated assignee liability to be included in its rated transactions. In connection with exposed loans, Standard & Poor's will continue with the third part of its analysis.

3. *Penalties*. For exposed loans, Standard & Poor's will consider whether the statute exposes the assignee or purchaser to monetary damages and, if so, whether such monetary damages are limited to a determinable dollar amount (i.e., the damages are capped). Standard & Poor's will perform this analysis for all types of monetary damages that may be assessed under the statute, including statutory, actual, and punitive damages, as well as any other type of monetary damages provided for in the statute.

If the damages for violation of a statute in connection with a given loan category are not capped, Standard & Poor's will not be able to size the potential liability into its credit analysis and thus will not, as a general matter, permit these loans to be included in Standard & Poor's rated transactions.

If, on the other hand, Standard & Poor's determines that, for any given loan category, the monetary damages are capped, as a general matter, Standard & Poor's will be able to size in its credit analysis the potential monetary impact of violating the statute and will continue with the fourth part of its analysis. In this regard, it should be noted that the ability of Standard & Poor's to size capped damages in its credit analysis is distinct from the question as to whether it would make economic sense to securitize loans, especially if the credit enhancement required equals or exceeds the monetary value of the loan. For example, some statutes provide for rescission or voidance of a predatory loan and require that all amounts paid, including principal and interest, be returned to the borrower. Other statutes permit a borrower to continue to hold a predatory loan, but forgive all interest that otherwise would be due. In addition, if a statute provides for punitive damages (even if these damages are capped), the amount of the damages may well exceed the loan value. In some of these instances, securitization of these loans may prove to be too costly.

If an anti-predatory lending statute imposes nonmonetary penalties on purchasers or assignees, e.g., restrictions or prohibitions on doing business with the governmental entity whose legislation is at issue, Standard & Poor's will review these penalties to determine the effect, if any, that these penalties will have on securitization transactions.

4. *Clarity of Statutory Violations; Safe Harbors*. As the fourth part of its analysis, Standard & Poor's will look to see how clearly an anti-predatory lending statute sets forth what constitutes prohibited actions and/or omissions for each exposed loan category. Standard & Poor's looks for clear language that would enable an originator, seller, or assignee of an exposed loan to comply with the statute. In addition, Standard & Poor's will look to see if the statute sets forth certain methods (for example, due diligence procedures and policies against the purchase of certain loans covered by the statute) that a purchaser or assignee can implement to avoid liability ("safe harbors").

Evaluation of Seller's Compliance Procedures and Creditworthiness

In addition to reviewing an anti-predatory lending statute for the factors discussed above, Standard & Poor's will also review the compliance procedures and creditworthiness of any entity that proposes to sell mortgage loans into a securitization ("seller"). In this regard, Standard & Poor's will review a seller's (i) compliance procedures, to determine if they are effective to identify (a) exposed loans, i.e., those subject to assignee liability, and (b) predatory loans, i.e., those that are in violation of the statute; and (ii) creditworthiness, to determine if the seller is willing and financially able to repurchase any predatory loan for a purchase price that would make a securitization trust whole for any costs incurred in connection with the predatory loan. These factors assume increased significance in transactions where the seller proposes to include exposed loans. Generally, Standard & Poor's requirements will be considerably more stringent for those transactions that pose an increased risk of inclusion of exposed loans that are predatory. Standard & Poor's requires that a securitization trust be kept whole to guard against any reduction of funds to pay investors in its rated securities.

Based upon its evaluation of all of the factors discussed above, as well as any other factors Standard & Poor's deems pertinent, Standard & Poor's will determine if any of the loans covered by an anti-predatory lending statute may be included in its rated transactions, and what, if any, additional credit enhancement may be required.

CONCLUSION

In summary, in its evaluation of the credit risk to investors of rated securities backed by mortgage loans governed by anti-predatory lending statutes, Standard & Poor's looks for statutory language that clearly sets forth what constitutes a violation under such a statute, which parties may be liable under the statute, the extent of such liability (monetary and otherwise), and whether any monetary liability is limited to a determinable dollar amount. Absent clarity on these issues, in order to best protect investors in rated securities, Standard & Poor's adopts a conservative interpretation of an anti-predatory lending statute, and may, in instances in which liability is unlimited, exclude mortgage loans governed by a given anti-predatory lending statute from transactions that it rates.

In offering these written comments, Standard & Poor's reiterates to the Honorable Members of the Subcommittee on Housing and Community Opportunity and the Subcommittee on Financial Institutions and Consumer Credit that, as a public policy matter, it is in favor of legislation that attempts to curb predatory and abusive lending practices. Standard & Poor's also acknowledges, however, that its role is to evaluate the credit risk to investors associated with anti-predatory lending legislation and not to recommend public policy, the making of which is the responsibility of elected officials.

**SUPPLEMENTAL MATERIALS
TO
STATEMENT OF PROPOSED TESTIMONY OF FRANK RAITER
MANAGING DIRECTOR
STANDARD & POOR'S CREDIT MARKET SERVICES**

**SUBMITTED TO SUBCOMMITTEE ON HOUSING AND COMMUNITY OPPORTUNITY AND SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT
U.S. HOUSE OF REPRESENTATIVES**

HEARING ON: PROTECTING HOMEOWNERS: PREVENTING ABUSIVE LENDING WHILE PRESERVING ACCESS TO CREDIT

Standard & Poor's Publications On Predatory Lending

1/16/03	Standard & Poor's to Disallow Georgia Fair Lending Act Loans
1/24/03	Standard & Poor's Comments on its Announcement Concerning Georgia Fair Lending Act
1/30/03	Impact of Georgia Fair Lending Act on the Georgia Housing and Finance Authority
2/7/03	Standard & Poor's Clarifies Position on Proposed Amendments to Georgia Fair Lending Act
2/24/03	Standard & Poor's to Rate Mortgage Pools That Include Loans Covered by NYC Local Law on Predatory Lending
3/11/03	Standard & Poor's Will Admit Georgia Mortgage Loans Into Rated Structured Finance Transactions
3/18/03	Repeal Provision of the Amended Georgia Fair Lending Act Reviewed by Standard & Poor's
3/27/03	Standard & Poor's Addresses New York State High-Cost Law
4/15/03	Evaluating Predatory Lending Laws: Standard & Poor's Explains its Approach
5/2/03	Standard & Poor's Addresses New Jersey Predatory Lending Law
5/2/03	Standard & Poor's CORRECT: Standard & Poor's Report Addresses New Jersey State Predatory Lending Law
6/20/03	Standard & Poor's Addresses Kentucky High-Cost Law
7/11/03	Standard & Poor's Addresses Arkansas Home Loan Protection Law
9/12/03	Standard & Poor's Addresses Amendment to Maine Truth in Lending Act
9/26/03	Standard & Poor's Addresses Nevada Anti-Predatory Lending Law
10/3/03	Standard & Poor's Announces Position on OCC's Preemption Order for the GFLA
10/7/03	Anti-Predatory Lending Laws Assume a Prominent Role in the U.S. RMBS Market
10/8/03	Standard & Poor's Clarifies Covered Home Loan Criteria Under NJ State Predatory Lending Law
10/8/03	Standard & Poor's Report Details Impact of Anti-Predatory Lending Laws in U.S. RMBS Market

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Research:

Standard & Poor's to Disallow Georgia Fair Lending Act Loans

Publication date: 16-Jan-2003

Credit Analyst: Natalie Abrams, Esq. , New York (1) 212-438-6607; Susan E Barnes, New York (1) 212-438-2394; Maureen Coleman, New York (1) 212-438-6626

NEW YORK (Standard & Poor's) Jan. 16, 2003--Standard & Poor's announced today that beginning Feb. 1, 2003, conforming-balance mortgage loans and manufactured housing loans governed by the Georgia Fair Lending Act (GFLA) will not be allowed in Standard & Poor's rated structured finance transactions. This determination is based on Standard & Poor's assessment that investors cannot be insulated from the potential liability resulting from violation of the GFLA either through credit enhancement or legal structure.

Loans governed by the GFLA are categorized as "Home Loans," "Covered Home Loans," or "High-Cost Home Loans," with each category having its own requirements and, in the case of Covered and High-Cost Home Loans, fees, points, and annual percentage rate tests. According to Standard & Poor's, violations of the statute will subject non-complying parties to potentially severe liability. Most important, however, the GFLA subjects assignees of Home Loans that violate the Act to potential liability. Thus, transaction parties in securitizations, including depositors, issuers and servicers, might all be subject to penalties for violations under the GFLA.

Since it is not feasible to ensure that all GFLA-governed loans have been originated in compliance with the Act--and given that the liability associated with non-compliance may subject depositors and trusts to liability exceeding a loan's principal balance--these loans are being disallowed and a representation that no mortgage loans meeting the definition of Home Loans will be required in transactions.

Mortgage loans on properties in Georgia not governed by the GFLA may be included in Standard & Poor's rated transactions. These loans include loans with an unpaid principal balance exceeding the current conforming loan size limit for single-family dwellings established by the Federal National Mortgage Association of $322,700. They also include reverse mortgages, bridge loans that finance the initial construction of the borrower's primary residence, agricultural loans, and loans for commercial purposes.

In addition to excluding Georgia loans governed by the GFLA from Standard & Poor's rated transactions, Standard & Poor's revised criteria will require that a new special purpose entity (SPE) be created for each transaction if an issuer chooses to use a two-tier structure with a pledge from the intermediate SPE to a trust (as opposed to using a double true sale structure). This requirement follows from the fact that legal structures using a pledge (rather than a sale) expose the depositor (pledgor) to liability since the assets are not sold but rather are held by the depositor. Therefore, if any of the loans the depositor pledges to any trust (whether or not the transaction is rated by Standard & Poor's) include Georgia Home Loans, all cashflow to other trusts, which may not have any Georgia Home Loans, will potentially be exposed should the depositor be subject to liability. Standard & Poor's may allow the same SPE to be used for multiple transactions where a representation has been made that the SPE has not transacted and will not transact in loans covered by the GFLA. This will not be necessary for transactions using a double true sale structure (where Standard & Poor's receives a true sale opinion from the seller to the depositor and from the depositor to the trust) since the loans are actually sold and subsequent cashflows are not intertwined with other issuances.

Finally, the GFLA requires that servicers follow certain procedures in servicing loans governed by the GFLA. Should the applicable procedures not be followed, the servicer may be subject to liability and an interruption of cashflow in securitizations may result. Given this, Standard & Poor's will now require all servicers who service GFLA-governed loans (even though such loans are not included in Standard & Poor's rated transactions) to maintain individual accounts for the deposit and remittance of payments pertaining to an issuance. No commingling of cash will be permitted for servicers who service loans subject to the GFLA.

Standard & Poor's will continue to monitor this and other pending predatory lending legislation and will update its criteria accordingly.

Standard & Poor's, a division of The McGraw-Hill Companies, provides widely recognized financial data, analytical research and investment and credit opinions to the global capital markets. With more than 5,000 employees located in 18 countries, Standard & Poor's is an integral part of the global financial infrastructure. Additional information is available at www.standardandpoors.com.

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Research:

Standard & Poor's Comments on its Announcement Concerning Georgia Fair Lending Act

Publication date: 24-Jan-2003

NEW YORK (Standard & Poor's) Jan. 24, 2003--Standard & Poor's today issued the following statement:

Standard & Poor's decision announced on January 16th not to rate mortgage-backed securities transactions that contain mortgages that might violate the provisions of the Georgia Fair Lending Act was based on Standard & Poor's opinion that the inclusion of such mortgages would negatively impact the creditworthiness of the rated transactions. The legislation, which prohibits predatory lending practices, provides that liability for predatory lending practices does not stop with the lender guilty of the predatory practices but transfers to all purchasers of the mortgage, including purchasers who had no knowledge or role in the predatory lending. Standard & Poor's believes that such transferred liability would negatively impact the investors in any mortgage-backed transaction that held such mortgages.

Our decision was based on credit considerations, and is not a comment on the public policy issues behind the legislation. We have had, and will continue to have, discussions with Georgia officials and others concerning our decision, and do not plan at this time to delay implementation beyond February 1st as we announced last week.

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Impact of Georgia Fair Lending Act on the Georgia Housing and Finance Authority

Publication date: 30-Jan-2003

Credit Analyst: Wendy Dolber, New York (1) 212-438-7994; Colleen Woodell, New York (1) 212-438-2118

Standard & Poor's Ratings Services announced on Jan. 16, 2003 that rated structured finance transactions could not include "home loans" as defined under the Georgia Fair Lending Act (GFLA) since it is not feasible to ensure that all GFLA-governed loans have been originated in compliance with the GFLA. While this prohibition applies to structured finance transactions, there are several reasons to differentiate between structured finance transactions and bond issuances by the Georgia Housing and Finance Authority (GHFA). Those include the financial strength of the GHFA and its willingness to indemnify bondholders against all liabilities resulting from violations of the GFLA. Accordingly, Standard & Poor's will continue to rate GHFA bonds supported by "home loans" defined under the Georgia Fair Lending Act under certain circumstances.

The GHFA typically does not make loans that fall into the "covered" and "high cost" loan categories, and Standard & Poor's will now require that GHFA represent and warrant in transaction documents that none of these loans is included in GHFA's transactions.

In its analysis of GHFA transactions, Standard & Poor's is relying on the general creditworthiness of the GHFA to pay the bonds in full in the event that GHFA is subject to any liability pursuant to GFLA. Analysis of GHFA's financial, managerial, and administrative capabilities, including loan production and asset management, is an important part of Standard & Poor's evaluation of GHFA's bond programs. Designated by Standard & Poor's as a "Top Tier" agency, the GHFA has a long track record of excellent loan administration as well as significant financial resources to cover potential losses resulting from violations of the GFLA. As a Top Tier agency, GHFA must ensure available unrestricted reserves of at least 4% of bonds outstanding.

As long as GHFA can effectively restrict loan purchases to avoid covered and high cost loans, can report effectively to Standard & Poor's, and, most importantly, can continue to provide a high level of financial support, Standard & Poor's will be able to continue to affirm ratings on GHFA transactions that include loans subject to the GFLA.

The GHFA is currently the only municipal issuer in Georgia under review as a result of the GFLA. All other municipal issuers will be subject to Standard & Poor's structured finance criteria announcement of Jan. 17, unless they are able to provide full indemnity for all potential losses under the GFLA.

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Research:

Standard & Poor's Clarifies Position on Proposed Amendments to Georgia Fair Lending Act

Publication date: 07-Feb-2003

NEW YORK (Standard & Poor's) Feb. 7, 2003--Standard & Poor's Ratings Services has received numerous inquiries regarding its position on proposed amendments to the Georgia Fair Lending Act (GFLA). The purpose of this release is to make clear that the credit considerations that led Standard & Poor's to conclude it could not rate transactions that include loans governed by the Act can be addressed in several different ways. Standard & Poor's, as a matter of policy, does not endorse any one approach over another.

The following are general approaches that would allow Standard & Poor's to rate transactions that include loans governed by the GFLA. One approach that would satisfy Standard & Poor's' concern about potential assignee liability would be for the proposed amendment clearly to remove such liability from the Act. A second approach would be for the amendment to exempt securitization trusts (or other issuing vehicles) and their special-purpose entity depositors from liability under the Act.

A third approach would provide for the Act to recognize that assignees--who are not responsible for originating loans in the first place--should be held to a lesser standard of liability than the originating creditors. One method to reduce assignee liability would be to create a safe harbor from liability (similar to that found in the federal statute, the Home Ownership and Equity Protection Act (HOEPA), and similar state statutes) for assignees who make good faith efforts to comply with the Act. In addition, assignee liability, if any, should be limited to the amount of the assignee's original investment and to the types of violations of the Act that could reasonably have been foreseen at the time that the loan was purchased by or assigned to the assignee. In this regard, amendments to the Act should clarify what loan features and/or lender actions violate the Act and distinguish among the different types of loans covered by the Act.

Standard & Poor's has reviewed and will continue to review proposed amendments. However, we reiterate that our role is to evaluate the credit risk of any proposed amendments and not to recommend public policy. That is the responsibility of elected public officials.

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Research:

S&P to Rate Mortgage Pools That Include Loans Covered by NYC Local Law on Predatory Lending

Publication date: 24-Feb-2003

NEW YORK (Standard & Poor's) Feb. 24, 2003--Standard & Poor's will continue to rate structured finance transactions that include mortgage loans originated under New York City Local Law No. 36 (2002), which became effective last week.

The New York City law has as its primary goal the elimination of predatory lending practices in the home mortgage industry. The law is designed to achieve this goal without imposing penalties on passive investors in mortgage-backed securities. Therefore, Standard & Poor's believes that the law does not create the kind of negative credit impact on securitizations that led to Standard & Poor's announcements on Jan. 16, 2003, and Feb. 7, 2003, regarding predatory lending laws and their effects on securitizations.

Standard & Poor's supports efforts to combat predatory lending and will continue to require representations and warranties that all mortgage loans included in Standard & Poor's rated structured finance transactions were originated in compliance with all applicable federal, state, and local statutes.

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Press Release

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Standard & Poor's Will Admit Georgia Mortgage Loans Into Rated Structured Finance Transactions

NEW YORK (Standard & Poor's) March 11, 2003 — Standard & Poor's announced today that it has reviewed the amendment to the Georgia Fair Lending Act that was signed into law on March 7 (the Amended Act). Based on its review, Standard & Poor's will rate structured finance transactions that include Georgia loans originated on or after March 7, 2003, in accordance with its criteria in effect at the time of the transactions, including receipt of appropriate representations and warranties related to compliance with the Amended Act.

The Amended Act imposes no liability on purchasers of Georgia loans that are not high-cost loans. Accordingly, Standard & Poor's will now rate transactions that include loans governed by the Amended Act that are not high-cost loans. However, the Amended Act continues to impose liability on purchasers of high-cost loans that violate the Amended Act. Since such liability is now capped, Standard & Poor's will review transactions that propose to include high-cost loans on a case-by-case basis. This review will evaluate the potential liability associated with high-cost loans. All transactions proposing to include high-cost loans must provide for credit support to cover this liability in full. Standard & Poor's anticipates that one manner of providing appropriate credit support is to require the re-purchase of high-cost loans that violate the Amended Act by a creditworthy institution. Standard & Poor's expects that the volume of Georgia high-cost loans will likely decrease over time.

Standard & Poor's is reviewing whether it can rate transactions that include loans originated between October 1, 2002 and March 7, 2003 that are governed by the prior act. Currently, Standard & Poor's will not rate transactions that include these loans.

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Repeal Provision of the Amended Georgia Fair Lending Act Reviewed by Standard & Poor's

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Publication date: 18-Mar-03, 15:55:04 EST
Reprinted from RatingsDirect

NEW YORK (Standard & Poor's) March 18, 2003--Standard & Poor's Ratings Services announced today that it has reviewed the amendment to the Georgia Fair Lending Act (GFLA) that was signed into law March 7, 2003, (the Amended Act) with respect to the repeal provision. At issue is whether the Amended Act should be applied retroactively to loans originated between Oct. 1, 2002 and March 7, 2003. Based on its review, Standard & Poor's will not rate structured finance transactions that include Georgia loans governed by the original GFLA.

There is a presumption in Georgia law, as with federal law, that a law is not retroactive unless it clearly states otherwise. The Amended Act does not explicitly provide for retroactivity. In addition, Georgia case law has interpreted that a repealing act will not be given retroactive operation with respect to rights and obligations under the repealed act.

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Standard & Poor's Addresses New York State High-Cost Law

NEW YORK (Standard & Poor's) March 27, 2003 - Standard & Poor's Ratings Services announced today that it has reviewed New York Banking Law Section 6L that is to become effective on April 1, 2003 (the Law). Based on its review, Standard & Poor's will rate structured finance transactions that include New York loans governed by the Law, provided that any potential assignee liability associated with these loans is covered in full, in accordance with Standard & Poor's criteria in effect at the time of the transactions.

The Law distinguishes between loans that are high-cost loans and those that are not high cost, and sets forth the calculations and thresholds for what constitutes a high-cost loan. Accordingly, lenders who wish to avoid making high-cost loans should be able to do so. For lenders that choose to make high-cost loans, the law prohibits certain practices and sets forth certain tests that must be adhered to. High-cost loans that fail to comply with the Law's requirements would be in violation of the Law. These violations could result in liability for the originator of the high-cost loans as well as for purchasers and assignees. Liability for purchasers and assignees would be in the form of a set off or counterclaim to foreclosure actions or other actions to collect on delinquent loans. Although this liability is capped, it may exceed the unpaid principal balance of the loan.

In evaluating rated transactions that include New York State-originated loans, Standard & Poor's will follow the analyses outlined below:

For transactions that do not include high-cost loans, Standard & Poor's will require the issuer to provide a representation and warranty that the loans in the rated pools are not high-cost. Standard & Poor's will require this representation from a credit worthy entity that can demonstrate that existing compliance procedures are adequate to track the calculations for identifying high-cost loans under the Law. Standard & Poor's will then look for repurchase of any loan that is in breach of this representation at a purchase price that will include any costs and damages incurred by the trust in connection with such loan. In addition, Standard & Poor's will continue to rely on the representation and warranty that the loans included in the pool were originated in compliance with all applicable laws.

Where issuers propose to include high-cost loans in a securitization, Standard & Poor's will impose criteria that are more stringent than those outlined for non-high cost loans. For these transactions, Standard & Poor's will require that the issuer represent and warrant that the high-cost loans comply with the Law. In this regard, Standard & Poor's will require issuers to demonstrate that their compliance procedures can adequately 1) *identify* high-cost loans, and 2) determine if these loans violate the Law (which may be difficult given certain ambiguities of the Law). Furthermore, the representation and warranty that the high-cost loans comply with the Law must be provided by an entity with sufficient financial strength to repurchase high-cost loans that are in violation as well as cover any contingent liability associated with securitizing New York State high-cost loans.

Loans originated in New York City will need to satisfy the criteria established in connection with New York State Law, as it is unclear whether New York State law preempts the recently passed New York City Ordinance.

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Research:

Evaluating Predatory Lending Laws: Standard & Poor's Explains its Approach

Publication date: 15-Apr-2003
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Federal, state, and local governmental bodies have enacted "predatory lending statutes" to protect borrowers from unfair, abusive, and deceptive lending practices. Among others, these predatory practices include the following: charging excessive interest or fees; making loans to a borrower that are beyond the borrower's financial ability to repay; charging excessive prepayment penalties; encouraging a borrower to refinance a loan notwithstanding the lack of benefit to the borrower; permitting loan acceleration to occur at a lender's discretion; and increasing interest rates upon default.

Predatory lending statutes are designed to protect borrowers from such practices, and Standard & Poor's strongly supports efforts to combat predatory lending. For several reasons, however, these statutes may also have the negative effect of reducing the availability of funds to such borrowers. First, a lender might reduce its lending in a given state to protect itself from being found in violation of the state's predatory lending statute. Second, a lender might reduce its business because the cost of lending in accordance with a statute's provisions might be uneconomical. Third, a lender might reduce its activities within a given state if the market for the sale of loans originated in that state is effectively eliminated. This would occur, for example, if a predatory lending statute imposes liability on purchasers or assignees of loans causing potential purchasers and assignees to reduce, or even cease, their purchasing to avoid liability under the statute.

Moreover, and most importantly from Standard & Poor's perspective, a predatory lending statute's imposition of liability on purchasers or assignees of mortgage loans ("assignee liability") might reduce the availability of funds to pay investors in securities backed by mortgage loans governed by the statute. This would occur if the purchaser or assignee were found to hold a loan that violated the statute ("predatory loan"), even if the purchaser or assignee did not itself engage in predatory lending practices. Therefore, in performing a credit analysis of structured transactions backed by residential mortgage loans, Standard & Poor's evaluates the impact a predatory lending statute might have on the availability of funds to pay investors in the rated securities.

Standard & Poor's Credit Analysis

Evaluation of Statutes

In performing this evaluation, Standard & Poor's considers, among other factors, whether the predatory lending statute provides for the following: (i) assignee liability; (ii) clearly delineated loan categories; (iii) penalties, including monetary damages, as well as restrictions or prohibitions on doing business with the governmental entity whose legislation is at issue; and (iv) clarity of statutory violations and safe harbors.

1. Assignee Liability. As the first part of its analysis, Standard & Poor's will review a predatory lending statute to see if it imposes assignee liability in connection with any type of loan covered by the statute (a loan with associated assignee liability is referred to in this discussion as an "exposed loan"). Standard & Poor's defines assignee liability as liability that attaches to a purchaser or assignee of a loan (including a securitization trust) simply by virtue of holding a predatory loan. A predatory lending statute may impose assignee liability in a direct action by the borrower or only defensively, i.e., in an action by the purchaser/assignee to enforce a loan. Typically, statutes that impose assignee liability permit a borrower to assert the same defenses against the purchaser or assignee as it could assert against the original lender.

If Standard & Poor's determines that no assignee liability is provided for under the statute, Standard & Poor's will, generally, permit loans covered by the statute to be included in Standard & Poor's rated transactions. If, on the other hand, Standard & Poor's determines that a given state's predatory lending statute does permit assignee liability, Standard & Poor's will continue with the second part of its analysis.

2. Statutory Loan Categories. As the second part of its analysis, Standard & Poor's examines the categories of loans that are identified in the statute. Standard & Poor's considers whether the language of the statute clearly distinguishes between those loans that are covered by the statute and those that are not, as well as among the various loan categories (for example, covered, high cost) covered by the statute. Standard & Poor's looks to see if a loan originator, a seller of loans into a securitization transaction, or a purchaser or assignee of loans would be able to determine what category of loan (according to the statute) the entity is originating, selling, or purchasing.

If Standard & Poor's concludes that the distinctions discussed above are not clearly set forth in the statute, then Standard & Poor's may not be able to rate transactions that include any loans originated in the relevant jurisdiction.

If, however, Standard & Poor's determines that the distinctions discussed above are clearly set forth in the statute, Standard & Poor's will determine for which loan categories the statute provides assignee liability. In general, and consistent with its approach for predatory lending statutes with no assignee liability for any loan categories (discussed above in section 1), Standard & Poor's will permit loans with no associated assignee liability to be included in its rated transactions. In connection with exposed loans, Standard & Poor's will continue with the third part of its analysis.

3. Penalties. For exposed loans, Standard & Poor's will consider whether the statute exposes the assignee or purchaser to monetary damages and, if so, whether such monetary damages are limited to a determinable dollar amount (i.e., the damages are capped). Standard & Poor's will perform this analysis for all types of monetary damages that may be assessed under the statute, including statutory, actual, and punitive damages, as well as any other type of monetary damages provided for in the statute. It should be noted that, even if the monetary damages provided for in a statute are capped for any given loan category, the cumulative effect might not be capped (for example, if the statute provides for class action suits and the size of the class is not determinable).

If the damages for violation of a statute in connection with a given loan category are not capped, Standard & Poor's will not be able to size the potential liability into its credit analysis and thus will not, as a general matter, permit these loans to be included in Standard & Poor's rated transactions.

If, on the other hand, Standard & Poor's determines that, for any given loan category, the monetary damages are capped, as a general matter, Standard & Poor's will be able to size in its credit analysis the potential monetary impact of violating the statute and will continue with the fourth part of its analysis. In this regard, it should be noted that the ability of Standard & Poor's to size capped damages in its credit analysis is distinct from the question as to whether it would make economic sense to securitize loans, especially if the credit enhancement required equals or exceeds the monetary value of the loan. For example, some statutes provide for rescission or voidance of a predatory loan and require that all amounts paid, including principal and interest, be returned to the borrower. Other statutes permit a borrower to continue to hold a predatory loan, but forgive all interest that otherwise would be due. In addition, if a statute provides for punitive damages (even if these damages are capped), the amount of the damages may well exceed the loan value. In some of these instances, securitization of these loans may prove to be too costly.

If a predatory lending statute imposes nonmonetary penalties on purchasers or assignees, e.g., restrictions or prohibitions on doing business with the governmental entity whose legislation is at issue, Standard & Poor's will review these penalties to determine the effect, if any, that these penalties will have on securitization transactions.

4. Clarity of Statutory Violations; Safe Harbors. As the fourth part of its analysis, Standard & Poor's will look to see how clearly a predatory lending statute sets forth what constitutes prohibited actions and/or omissions for each exposed loan category. Standard & Poor's looks for clear language that

would enable an originator, seller, or assignee of an exposed loan to comply with the statute. In addition, Standard & Poor's will look to see if the statute sets forth certain methods (for example, due diligence procedures and policies against the purchase of certain loans covered by the statute) that a purchaser or assignee can implement to avoid liability ("safe harbors").

Evaluation of Sellers' Compliance Procedures and Creditworthiness

In addition to reviewing a predatory lending statute for the factors discussed above, Standard & Poor's will also review a seller's (i) compliance procedures, to determine if they are effective to identify (a) exposed loans, i.e., those subject to assignee liability, and (b) predatory loans, i.e., those that are in violation of the statute; and (ii) creditworthiness, to determine if a seller is willing and financially able to repurchase any predatory loan for a purchase price that would make a securitization trust whole for any costs incurred in connection with the predatory loan. These factors assume increased significance in transactions where the seller proposes to include exposed loans. Generally, Standard & Poor's requirements will be considerably more stringent for those transactions that pose an increased risk of inclusion of exposed loans that are predatory.

Based upon its evaluation of all of the factors discussed above, as well as any other factors Standard & Poor's deems pertinent, Standard & Poor's will determine if any of the loans covered by a predatory lending statute may be included in its rated transactions, and what, if any, additional credit enhancement may be required.

How Have Standard & Poor's Credit and Legal Analyses Been Applied?

To date, Standard & Poor's has reviewed the Georgia Fair Lending Act (GFLA) and its subsequent amendment, which became effective in March 2003, as well as the recently enacted New York City and New York State predatory lending laws. In each instance, Standard & Poor's applied the analyses outlined in this article to arrive at its position.

Georgia

In the case of the GFLA, prior to its amendment, the uncapped assignee liability for predatory loans, along with ambiguity relating to the various loan categories and to compliance with the statute, resulted in Standard & Poor's decision to exclude all loans covered by the GFLA from its rated securitizations.

By contrast, the amended GFLA imposes liability only on purchasers and assignees of Georgia loans that are high-cost loans. The amended law also eliminates the "covered loan" category, making it easier for lenders to distinguish between loans that are high cost and those that are not. Lastly, the amendment also provides for a safe harbor protecting parties who do not transact in high-cost loans from liability against the inadvertent purchase of high-cost loans. Accordingly, Standard & Poor's announced in a March 11, 2003, press release that it would rate transactions that include Georgia loans that are not high cost. The release went on to explain that with respect to transactions that propose to include high-cost loans, although the amended GFLA continues to impose liability on purchasers and assignees of predatory high-cost loans, because this liability is now capped, Standard & Poor's may consider rating such transactions. For these transactions, however, the criteria imposed will be stringent, and Standard & Poor's will need to ensure that any potential liability associated with high-cost loans, should they be found to be predatory, is covered. In this regard, any issuer proposing to include Georgia high-cost loans in a securitization will be required to demonstrate that it can effectively: i) identify high-cost loans; and ii) identify which high-cost loans are predatory and prevent their transfer into the securitization. Additionally, because of the increased risks associated with the inclusion of high-cost loans in securitizations, Standard & Poor's will require that the representation and warranty that the loans are in compliance with all applicable laws be provided by an entity that has sufficient creditworthiness and is willing and financially able to repurchase predatory high-cost loans, as well as cover any contingent liability associated with securitizing Georgia high-cost loans.

New York State

Standard & Poor's took a similar approach with respect to the New York state predatory lending law, which became effective April 1, 2003. The New York State statute clearly distinguishes between loans that are high-cost and those that are not high cost, and sets forth the calculations and thresholds for what constitutes a high-cost loan. Accordingly, lenders who wish to avoid making high-cost loans in New York State should be able to do so. For lenders who choose to make high-cost loans, the law prohibits certain practices and sets forth certain tests that must be adhered to. High-cost loans that fail to comply with the new law's requirements would be predatory. Violations of the statute could result in liability for the originator of the high-cost loans, as well as for purchasers and assignees. Liability for purchasers and assignees would be in the form of a set-off or counterclaim to foreclosure actions or other actions to collect on delinquent loans. Although this liability is capped, it may very well exceed the unpaid principal balance of the loan.

In evaluating rated transactions that include New York State-originated loans, Standard & Poor's announced March 27, 2003, that it will evaluate transactions that include New York State loans as follows:

For transactions that do not include high-cost loans, Standard & Poor's will require the issuer to provide a representation and warranty that the loans in the rated pools are not high cost. Standard & Poor's will require this representation from a creditworthy entity that can demonstrate that existing compliance procedures are adequate to track the calculations for identifying high-cost loans under the New York law. Standard & Poor's will then look for repurchase of any loan that is in breach of this representation at a purchase price that will include any costs and damages incurred by the trust in connection with such a loan. Standard & Poor's believes these measures are necessary to protect against liability that would arise with the inadvertent inclusion of high-cost loans, particularly since the New York State law does not provide for a safe harbor to protect against such an occurrence. Finally, Standard & Poor's will continue to rely on the representation and warranty that the loans included in the pool were originated in compliance with all applicable laws.

Where issuers propose to include New York high-cost loans in a securitization, Standard & Poor's will follow the same criteria outlined above for Georgia high cost loans.

New York City

On the other hand, the recently passed New York City ordinance is an example of a predatory lending law that does not impose monetary damages on purchasers and assignees. As with many other predatory lending laws, the New York City ordinance has as its primary goal the elimination of predatory lending practices in the home mortgage industry. But unlike some of the other predatory lending laws, the New York City law is designed to achieve this goal without imposing monetary penalties on passive investors in mortgage-backed securities. Therefore, because the law does not create the kind of negative credit impact on securitizations that other predatory lending laws do, Standard & Poor's decided it could continue to allow loans originated in New York City in its rated transactions.

Standard & Poor's Criteria Evolve Over Time

Standard & Poor's regularly reviews its criteria to keep current with changes in the law in the area of predatory lending. These criteria are not stagnant, but evolve over time. Standard & Poor's welcomes market participants to consult with it for clarification regarding its predatory lending criteria and to ask any questions regarding future developments as they arise. Standard & Poor's will continue to publish its criteria to keep market participants informed of any new approaches in this area.

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Research:

Standard & Poor's Addresses New Jersey Predatory Lending Law

Publication date: 02-May-2003
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(Editor's Note: When this commentary was published earlier today, much of the text was missing due to technical difficulties. The complete article follows.)

Standard & Poor's Ratings Services announced today that it has reviewed the New Jersey Home Ownership Security Act of 2002 that will become effective on or after Nov. 27, 2003 (the Act). Based on its review, Standard & Poor's has concluded that it will permit certain New Jersey loans governed by the Act and originated on or after the effective date to be included in its rated structured finance transactions.

Loans That Will Be Accepted into Standard & Poor's Rated Transactions

Loans Not Governed by the Act

Mortgage loans on properties in New Jersey not governed by the Act may be included in Standard & Poor's structured finance transactions. Among others, these loans include reverse mortgage loans and loans on homes that are not the borrower's principal dwelling, such as loans to finance second homes and investor properties. For these loans, Standard & Poor's will continue to rely on its standard representation and warranty that the loans included in the pool were originated in compliance with all applicable laws.

Loans Governed by the Act

For loans governed by a predatory lending statute, Standard & Poor's evaluates the impact the statute may have on the availability of funds to pay investors of its rated securities. In its review of the Act, Standard & Poor's followed its general approach set forth in its recently published article on evaluating predatory lending statutes. (For a discussion of Standard & Poor's general approach to evaluating predatory lending statutes, see "Evaluating Predatory Lending Laws: Standard & Poor's Explains its Approach," published on RatingsDirect on April 15, 2003).

The Act categorizes loans as "Home Loans," "Covered Home Loans," and "High-Cost Home Loans" and sets forth certain practices and prohibitions in connection with these categories. In addition, the Act sets forth certain prohibitions for Home Loans that are made in connection with home improvements ("Home Improvement Loans") and manufactured homes ("Manufactured Housing Loans"). Violations of the Act could result in monetary liability for the originator of the loans and, for some loan categories, for purchasers and assignees.

For Home Loans that are not Covered Home Loans, High-Cost Home Loans, Home Improvement Loans or Manufactured Housing Loans, the Act does not provide for assignee liability. Based on Standard & Poor's stated criteria, these Home Loans will be admitted into Standard & Poor's rated structured finance transactions, provided (i) the Home Loan is either for the purpose of purchasing a home or a rate-term refinancing; and (ii) the seller into the securitization structure provides a representation and warranty that the loans in the rated pools are not Excluded Loans (see below). Standard & Poor's will require this representation from a creditworthy entity that can demonstrate that existing compliance procedures are effective to identify and exclude Excluded Loans under the Act (including compliance with the Act's safe harbor provisions for the exclusion of High-Cost Loans). Standard & Poor's will then look for repurchase of any loan that is in breach of this representation at a purchase price that will include any costs and damages incurred by the trust in connection with such loan. Standard & Poor's believes these measures are necessary to protect against liability that would arise with the inadvertent inclusion of Excluded Loans. In addition, Standard & Poor's will continue to rely on the representation and warranty that the loans included in the pool were originated in compliance with all applicable laws.

Loans That Will Not Be Accepted in Standard & Poor's Rated Transactions

For all other loan categories (Covered Home Loans, High-Cost Home Loans, all Home Improvement Loans, all Manufactured Housing Loans, and Home Loans that are cash-out refinancings or junior lien mortgage loans (open or closed-end) (collectively, Excluded Loans), the Act provides the potential for assignee liability (loans exposed to assignee liability are referred to as Exposed Loans). Although damages for some of these loan categories are capped under the Act, for the reasons set forth below, Standard & Poor's will not permit these loans to be included in its rated structured finance transactions.

First, in addition to the damages available to a borrower under the Act, the Act permits a borrower to elect to recover damages under either the Act or New Jersey's Consumer Fraud Act (CFA), which provides for recovery of treble the damages sustained by a borrower, plus costs. Because Standard & Poor's believes the Act is unclear as to whether a borrower may recover under the CFA in a suit against assignees for a violation under the Act, Standard & Poor's believes it must adopt the more conservative approach and factor into its credit analysis the possibility that treble actual damages might be recoverable against an assignee. Moreover, because the language of the CFA does not define actual damages, for the purposes of its credit analysis, Standard & Poor's must assume that such damages are not limited to a determinable dollar amount (i.e., the damages are not capped). Thus, notwithstanding any caps on damages that may be provided for under the Act, Standard & Poor's believes it is unable to quantify the assignee damages that might be obtainable under the CFA for violations of the Act. Therefore, the right provided for in the Act to elect damages under either the Act or the CFA was critical in Standard & Poor's determination to exclude all Exposed Loans from its structured finance transactions.

However, even if it were clear that a borrower could not recover damages against assignees under the CFA, for the reasons stated in the following paragraph, for certain loan categories, Standard & Poor's believes the damages may still be unquantifiable under the Act. Therefore, in accordance with its stated criteria, Standard & Poor's would still exclude such loans from its structured finance transactions.

Specifically, although damages against assignees of Home Improvement Loans and Manufactured Housing Loans that are in violation of the Act are capped, because the Act does not preclude class action suits for these categories, the cumulative damages might not be capped if the class size is not determinable. In addition, for these loan categories, Standard & Poor's believes that a borrower may recover under more than one section of the Act, each of which separately provides for damages that may equal or exceed the principal balance of the loan, thereby posing the potential problem of cumulative damages. With respect to Home Loans that are cash-out refinancings or junior lien mortgage loans (open or closed-end), Standard & Poor's believes it is necessary to exclude these loans because the funds from these loans could be used for the purpose of home improvement (which loans carry the potential for assignee liability) and this fact may not be disclosed upon origination. Finally, for High-Cost Loans held by assignees who fail to meet the Act's safe harbor provisions for excluding High-Cost loans, the Act clearly provides for uncapped statutory and punitive damages and, thus, would be excluded from Standard & Poor's rated structured finance transactions.

On the other hand, if it were clear that a borrower could not recover damages against assignees under the CFA, because the damages for Covered Home Loans are capped under the Act, Standard & Poor's would consider permitting Covered Home Loans into its rated pools, provided that the loans are not Home Improvement Loans, Manufactured Housing Loans, or High-Cost Home Loans.

Summary of Standard & Poor's Criteria set forth above for New Jersey Loans Governed by the Act

Loans allowed into Standard & Poor's rated structured transactions:

*--Home Loans (except for Home Loans that are refinanced transactions and junior lien mortgage loans)

Loans not allowed into Standard & Poor's rated structured transactions:

*--High-Cost Home Loans

*--Covered Home Loans

*--Home Improvement Loans

*--Manufactured Housing Loans

Standard & Poor's Criteria Evolve Over Time

Market participants should note that until the Act becomes effective Standard & Poor's will continue to apply its current criteria for inclusion of New Jersey loans in rated transactions.

Standard & Poor's regularly reviews its criteria to keep current with changes in the law in the area of predatory lending. These criteria are not stagnant, but evolve over time. Standard & Poor's will continue to publish its criteria to keep market participants informed of any new approaches in this area.

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S&PCORRECT: S&P Report Addresses New Jersey State Predatory Lending Law

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(Editor's Note: When this media release was published earlier today, much of the text was missing due to technical difficulties. The complete article follows.)

NEW YORK (Standard & Poor's) May 2, 2003--In a commentary released today, Standard & Poor's Ratings Services announced that it has reviewed the New Jersey Home Ownership Security Act of 2002 that will become effective on or after November 27, 2003 (the Act). Based on its review, Standard & Poor's has concluded that it will permit certain New Jersey loans governed by the Act and originated on or after the effective date of the Act to be included in its rated structured finance transactions.

The commentary, "Standard & Poor's Addresses New Jersey State Predatory Lending Law," details the New Jersey loans that will be accepted into and excluded from Standard & Poor's rated transactions.

Mortgage loans on properties in New Jersey not governed by the Act may be included in Standard & Poor's structured finance transactions. Among others, these loans include reverse mortgage loans and loans on homes that are not the borrower's principal dwelling, such as loans to finance second homes and investor properties.

"In reviewing the New Jersey law, we followed the general approach we have taken in reviewing other predatory lending acts, such as the Georgia Fair Lending Act (GFLA) and New York City's recent legislation," said Joanne W. Rose, executive managing director of global structured finance at Standard & Poor's. "As with all the predatory lending statutes we have evaluated to date, Standard & Poor's assesses the impact the statute may have on our ability to rate the amount of credit risk in structured finance pools. If we can't quantify the risk, we can't rate the structure." Standard & Poor's general approach is set forth in its recently published article on evaluating predatory lending statutes (see "Evaluating Predatory Lending Laws: Standard & Poor's Explains its Approach," released on April 15, 2003 on RatingsDirect.).

Because the Act provides unquantifiable assignee liability for violations relating to certain loan categories under the Act, Standard & Poor's will exclude from its rated structured finance transactions all loans in such categories.

Standard & Poor's criteria for New Jersey loans governed by the Act can be summarized as follows:

Loans allowed into Standard & Poor's rated structured transactions:

*--Home Loans (except for Home Loans that are cash-out refinanced transactions and junior lien mortgage loans)

Loans not allowed into Standard & Poor's rated structured transactions:

*--High-Cost Home Loans
*--Covered Home Loans
*--Home Improvement Loans
*--Manufactured Housing Loans

Market participants should note that until the Act becomes effective Standard & Poor's will continue to apply its current criteria for inclusion of New Jersey loans in rated transactions.

Standard & Poor's regularly reviews its criteria to keep current with changes in the law in the area of predatory lending. These criteria are not stagnant, but evolve over time. Standard & Poor's will continue to publish its criteria to keep market participants informed of any new approaches in this area.

The commentary, "Standard & Poor's Addresses New Jersey State Predatory Lending Law," is available on RatingsDirect, Standard & Poor's Web-based credit analysis system, at www.ratingsdirect.com. It is also available on Standard & Poor's Web site at www.standardandpoors.com. Go to Fixed Income, under "Browse by Sector" choose Structured Finance, and then under Commentary & News scroll down to the desired piece, dated May 2.

"Evaluating Predatory Lending Laws: Standard & Poor's Explains its Approach," providing a fuller discussion of Standard & Poor's general approach to evaluating predatory lending statutes, is also available on RatingsDirect, Standard & Poor's Web-based credit analysis system, and on Standard & Poor's Web site at www.standardandpoors.com. Go to Fixed Income, under "Browse by Sector" choose Structured Finance, and then under Commentary & News scroll down to the desired article, dated April 15.

Members of the media may contact Mimi Barker at (212) 438-5054 or Adam Tempkin (in Orlando, FL) at (917) 375-0069 (cell).

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Research:

Standard & Poor's Addresses Kentucky High-Cost Law

Publication date: 20-Jun-2003
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NEW YORK (Standard & Poor's) June 20, 2003--Standard & Poor's Ratings Services announced today that it has reviewed the predatory lending provisions of Kentucky HB 287 (the Act) that is to become effective on June 24, 2003. Based on its review, Standard & Poor's will rate structured finance transactions that include Kentucky loans governed by the Act in accordance with its criteria set forth below.

The Act distinguishes between loans that are high-cost home loans and those that are not and sets forth the terms for what constitutes a high-cost home loan. Accordingly, lenders who wish to avoid making high-cost home loans should be able to do so. For lenders that choose to make high-cost home loans, the Act prohibits certain practices and sets forth certain rules to which a lender must adhere. High-cost home loans that fail to comply with the Act's requirements would violate the Act. These violations could result in liability for the originator of the high-cost home loans. In addition, if these violations are apparent on the face of the disclosure document required under the Act or on the face of the promissory note, the violations could also result in liability for purchasers or assignees of the high-cost home loan.

With respect to high-cost home loans, a violation of the Act is deemed to be also a violation of Kentucky's usury laws, as well as Kentucky's unfair and deceptive trade laws. Under the Act, borrowers may recover damages under either the State's usury laws or the State's unfair and deceptive trade laws, but not both. Under Kentucky's usury laws, penalties may include forfeiture of the entire interest on the loan or repayment of twice the interest paid in excess of the legal rate, as well as fines of up to $50 per violation. Under Kentucky's unfair and deceptive trade laws, penalties may include restoration of money and property, as well as actual damages, equitable relief, and attorneys' fees and costs. In addition, "where appropriate," a borrower may seek punitive damages.

For loans governed by a predatory lending statute, Standard & Poor's evaluates the impact the statute may have on the availability of funds to pay investors of its rated securities. In its review of the Act, Standard & Poor's followed its general approach set forth in its recently published article on evaluating predatory lending statutes (For a discussion of Standard & Poor's general approach to evaluating predatory lending statutes, see "Evaluating Predatory Lending Laws: Standard & Poor's Explains its Approach," published on RatingsDirect on April 15, 2003).

In evaluating rated transactions that include Kentucky originated loans, Standard & Poor's will follow the analyses outlined below:

For transactions that do not include high-cost home loans, Standard & Poor's will require the seller to provide a representation and warranty that the loans in the rated pools are not high-cost home loans. Standard & Poor's will require this representation from a creditworthy entity that can demonstrate that existing compliance procedures are effective to track the calculations for identifying high-cost home loans under the Act. Standard & Poor's will then look for repurchase of any loan that is in breach of this representation at a purchase price that will include any costs and damages incurred by the issuing trust in connection with such loan. In addition, Standard & Poor's will continue to rely on the representation and warranty that the loans included in the pool were originated in compliance with all applicable laws, including, but not limited to, all applicable predatory and abusive lending laws.

Where sellers propose to include high-cost home loans in a securitization, Standard & Poor's will impose criteria that are more stringent than those outlined for non-high-cost home loans. For these transactions, Standard & Poor's will require its standard compliance representation set forth above. In addition, Standard & Poor's will require issuers to (i) demonstrate that their compliance procedures can effectively identify high-cost home loans and (ii) conduct a loan by loan review of (a) the disclosure provided in accordance with the Act and (b) the promissory note, in order to determine that these loans do not violate the Act. Furthermore, the representation and warranty that the high-cost home loans comply with all applicable laws must be provided by an entity with sufficient financial strength to repurchase high-cost home loans that are in violation, as well as cover any contingent liability associated with securitizing Kentucky high-cost home loans.

Although the Act provides the potential for punitive damages that may be uncapped, Standard & Poor's is adopting the criteria set forth above because purchasers and assignees are held liable only for violations apparent on the face of the disclosure and promissory note. Where sellers propose to include Kentucky high-cost home loans in a securitization, because of the loan by loan review requirement discussed above, together with the compliance representation and the accompanying repurchase obligation, Standard & Poor's believes that the issuer of the rated securities will be protected.

Standard & Poor's regularly reviews its criteria to keep current with changes in the law in the area of predatory lending. These criteria are not stagnant, but evolve over time. Standard & Poor's will continue to publish its criteria to keep market participants informed of any new approaches in this area.

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Research:

Standard & Poor's Addresses Arkansas Home Loan Protection Law

Publication date: 11-Jul-2003

Credit Analyst: Maureen Coleman, Esq. , New York (1) 212-438-6626; Natalie Abrams, Esq. , New York (1) 212-438-6607

NEW YORK (Standard & Poor's) July 11, 2003--Standard & Poor's Ratings Services announced today that it has reviewed Arkansas House Bill 2598 (the Act) that is to become effective on July 16, 2003. Based on its review, Standard & Poor's will rate structured finance transactions that include Arkansas loans governed by the Act in accordance with its criteria set forth below.

The Act distinguishes between loans that are high-cost home loans and those that are not and sets forth the terms for what constitutes a high-cost home loan. Accordingly, lenders who wish to avoid making high-cost home loans should be able to do so. For lenders that choose to make high-cost home loans, the Act prohibits certain practices and sets forth certain rules to which a lender must adhere. High-cost home loans that fail to comply with the Act's requirements would violate the Act. These violations could result in liability for the originator of the high-cost home loans. In addition, these violations could also result in liability for purchasers or assignees of high-cost home loans who do not meet the Act's safe harbor provisions. Although the liability of purchasers and assignees for a loan that violates the Act may exceed the unpaid principal balance of the loan, this liability is capped.

For loans governed by a predatory lending statute, Standard & Poor's evaluates the impact the statute may have on the availability of funds to pay investors of its rated securities. In its review of the Act, Standard & Poor's followed its general approach set forth in its recently published article on evaluating predatory lending statutes (For a discussion of Standard & Poor's general approach to evaluating predatory lending statutes, see "Evaluating Predatory Lending Laws: Standard & Poor's Explains its Approach," published on RatingsDirect on April 15, 2003).

In evaluating rated transactions that include Arkansas originated loans, Standard & Poor's will follow the analyses outlined below:

For transactions that do not include high-cost home loans, Standard & Poor's will require the seller to provide a representation and warranty that the loans in the rated pools are not high-cost home loans. Standard & Poor's will require this representation from a creditworthy entity that can demonstrate that existing compliance procedures are effective to track the calculations for identifying high-cost home loans under the Act. Standard & Poor's will then look for repurchase of any loan that is in breach of this representation at a purchase price that will include any costs and damages incurred by the issuing trust in connection with such loan. In addition, Standard & Poor's will continue to rely on the representation and warranty that the loans included in the pool were originated in compliance with all applicable laws, including, but not limited to, all applicable predatory and abusive lending laws.

Where sellers propose to include high-cost home loans in a securitization, Standard & Poor's will impose criteria that are more stringent than those outlined for non-high-cost home loans. For these transactions, Standard & Poor's will require its standard compliance representation set forth above. In addition, Standard & Poor's will require sellers to demonstrate that their compliance procedures can effectively (i) identify high-cost home loans and (ii) determine that these loans do not violate the Act. Furthermore, the representation and warranty that the high-cost home loans comply with all applicable laws must be provided by an entity with sufficient financial strength to repurchase high-cost home loans that are in violation, as well as cover any contingent liability associated with securitizing Arkansas high-cost home loans.

Finally, the Act prohibits certain practices that may be servicing related. Specifically, the imposition of a payoff/release fee of more than $20 or violation of the provision requiring that payoff balances be provided to a borrower within a specific timeframe could result in substantial monetary damages for assignees of a high-cost home loan, or even the voiding of the loan. Accordingly, for transactions that propose to include Arkansas high-cost home loans, in addition to the requirements set forth above, Standard & Poor's will require that the seller indemnify the issuing trust for any damages it incurs arising out of the practices described in this paragraph.

Standard & Poor's regularly reviews its criteria to keep current with changes in the law in the area of predatory lending. These criteria are not stagnant, but evolve over time. Standard & Poor's will continue to publish its criteria to keep market participants informed of any new approaches in this area.

Members of the media may contact Adam Tempkin, Media Relations Manager, at 212-438-7530 or adam_tempkin@standardandpoors.com.

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Research:

Standard & Poor's Addresses Amendment to Maine Truth in Lending Act

Publication date: 12-Sep-2003

Credit Analyst: Maureen Coleman, Esq. , New York (1) 212-438-6626; Natalie Abrams, Esq. , New York (1) 212-438-6607

NEW YORK (Standard & Poor's) Sept. 12, 2003--Standard & Poor's Ratings Services announced today that it has reviewed Maine House Bill 383 L.D. 494 (the Amendment) that is to become effective on September 13, 2003. The Amendment expands upon Maine's existing high-rate, high-fee lending provisions which were enacted and included as part of its Truth In Lending Act in June of 1995 (the original law and the Amendment are referred to in this release as the Amended Law). Based on its review, Standard & Poor's will rate structured finance transactions that include Maine loans governed by the Amended Law in accordance with its criteria set forth below.

The Amended Law distinguishes between loans that are high-rate, high-fee loans (these loans shall be referred to as high cost in this release) and those that are not and sets forth the terms for what constitutes a high-cost loan. Accordingly, lenders who wish to avoid making high-cost loans should be able to do so. For lenders that choose to make high-cost loans, the Amended Law prohibits certain practices and sets forth certain rules to which a lender must adhere. High-cost loans that fail to comply with the Amended Law requirements would violate the Amended Law. These violations could result in liability for the originator of the high-cost loans. In addition, these violations could also result in liability for purchasers or assignees of high-cost home loans. Although the liability of purchasers and assignees for a loan that violates the Amended Law may exceed the unpaid principal balance of the loan, this liability is capped. .

For loans governed by a predatory lending statute, Standard & Poor's evaluates the impact the statute may have on the availability of funds to pay investors of its rated securities. In its review of the Amended Law, Standard & Poor's followed its general approach set forth in its recently published article on evaluating predatory lending statutes (For a discussion of Standard & Poor's general approach to evaluating predatory lending statutes, see "Evaluating Predatory Lending Laws: Standard & Poor's Explains its Approach," published on RatingsDirect on April 15, 2003).

In evaluating rated transactions that include Maine originated loans, Standard & Poor's will follow the analyses outlined below:

For transactions that do not include high-cost loans, Standard & Poor'swill require the seller to provide a representation and warranty that the loans in the rated pools are not high-cost loans. Standard & Poor's will require this representation from a creditworthy entity that can demonstrate that existing compliance procedures are effective to track the calculations for identifying high-cost loans under the Amended Law. Standard & Poor's will then look for repurchase of any loan that is in breach of this representation at a purchase price that will include any costs and damages incurred by the issuing trust in connection with such loan. In addition, Standard & Poor's will continue to rely on the representation and warranty that the loans included in the pool were originated in compliance with all applicable laws, including, but not limited to, all applicable predatory and abusive lending laws.

Where sellers propose to include high-cost loans in a securitization, Standard & Poor's will impose criteria that are more stringent than those outlined for non-high-cost loans. For these transactions, Standard & Poor's will require its standard compliance representation set forth above. This representation and warranty must be provided by an entity with sufficient financial strength to repurchase high-cost loans that are in violation, as well as cover any contingent liability associated with securitizing Maine high-cost loans. In addition, Standard & Poor's will require issuers to demonstrate that their compliance procedures can effectively: (i) identify high-cost loans and (ii) determine that these loans do not violate the Amended Law.

Standard & Poor's regularly reviews its criteria to keep current with changes in the law in the area of predatory lending. These criteria are not stagnant, but evolve over time. Standard & Poor's will continue to publish its criteria to keep market participants informed of any new approaches in this area.

Members of the media may contact Adam Tempkin, Media Relations Manager, at 212-438-7530 or adam_tempkin@standardandpoors.com.

Contact: Maureen Coleman, Esq., New York (1) 212-438-6626
Natalie Abrams, Esq., New York (1) 212-438-6607.

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Research:

Standard & Poor's Addresses Nevada Anti-Predatory Lending Law

Publication date: 26-Sep-2003

Credit Analyst: Natalie Abrams, Esq , New York (1) 212-438-6607; Maureen Coleman, Esq. , New York (1) 212-438-6626

NEW YORK (Standard & Poor's) Sept. 26, 2003--Standard & Poor's Ratings Services announced today that it has reviewed Nevada Assembly Bill No. 284 (the Act) that is to become effective on Oct. 1, 2003. Based on its review, Standard & Poor's will rate structured finance transactions that include Nevada loans governed by the Act in accordance with its criteria set forth below.

The Act defines certain mortgage loans as "Home loans" using the definition set forth under Section 152 of the Home Ownership and Equity Protection Act of 1994 (HOEPA), and related regulations. Accordingly, lenders who wish to avoid making Home loans governed by the Act should be able to do so. For lenders that choose to make Home loans, the Act prohibits certain practices and sets forth certain rules to which a lender must adhere. Home loans that fail to comply with the Act's requirements would violate the Act. These violations could result in liability for the originator of the Home loans. In addition, these violations may result in liability for purchasers or assignees of Home loans that violate the Act. Although the liability of purchasers and assignees for a loan that violates the Act may exceed the unpaid principal balance of the loan, this liability is capped.

For loans governed by an anti-predatory lending statute, Standard & Poor's evaluates the impact the statute may have on the availability of funds to pay investors of its rated securities. In its review of the Act, Standard & Poor's followed its general approach set forth in its recently published article on evaluating anti-predatory lending statutes (For a discussion of Standard & Poor's general approach to evaluating anti-predatory lending statutes, see "Evaluating Predatory Lending Laws: Standard & Poor's Explains its Approach," published on RatingsDirect, Standard & Poor's Web-based credit analysis system, on April 15, 2003).

In evaluating rated transactions that include Nevada originated loans, Standard & Poor's will follow the analyses outlined below:

For transactions that do not include Home loans governed by the Act, Standard & Poor's will require the seller to provide a representation and warranty that the loans in the rated pools are not Home loans. Standard & Poor's will require this representation from a creditworthy entity that can demonstrate that existing compliance procedures are effective to track the calculations for identifying Home loans under the Act. Standard & Poor's will then look for repurchase of any loan that is in breach of this representation at a purchase price that will include any costs and damages incurred by the issuing trust in connection with such loan. In addition, Standard & Poor's will continue to rely on the representation and warranty that the loans included in the pool were originated in compliance with all applicable laws, including, but not limited to, all applicable anti-predatory and abusive lending laws.

Where sellers propose to include Home loans governed by the Act in a securitization, Standard & Poor's will impose criteria that are more stringent than those outlined for non-Home loans. For these transactions, Standard & Poor's will require its standard compliance representation set forth above. In addition, Standard & Poor's will require issuers to demonstrate that their compliance procedures can effectively (i) identify Home loans and (ii) determine that these loans do not violate the Act. Furthermore, the representation and warranty that the Home loans comply with all applicable laws must be provided by an entity with sufficient financial strength to repurchase Home loans that are in violation, as well as cover any contingent liability associated with securitizing Nevada Home loans.

Standard & Poor's regularly reviews its criteria to keep current with changes in the law in the area of predatory lending. These criteria are not stagnant, but evolve over time. Standard & Poor's will continue to publish its criteria to keep market participants informed of any new approaches in this area.

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Research:

Standard & Poor's Announces Position on OCC's Preemption Order for the GFLA

Publication date: 03-Oct-2003

Credit Analyst: Natalie Abrams, Esq., New York (1) 212-438-6607; Maureen Coleman, Esq., New York (1) 212-438-6626

NEW YORK (Standard & Poor's) Oct. 3, 2003--Standard & Poor's Ratings Services announced today that it is revising its criteria for inclusion in securitizations of Georgia Fair Lending Act (GFLA) governed loans made by national banks and their operating subsidiaries, as set forth below. These revisions apply to loans governed by both the original GFLA and the amended GFLA, each as defined below. Standard & Poor's revised criteria are based upon its review of a Determination and Order (the Order) issued by the Office of the Comptroller of the Currency (the OCC) on July 31, 2003 in response to a request from National City Bank, N.A., National City Bank of Indiana, N.A., and their operating subsidiaries.

For loans governed by a predatory lending statute, Standard & Poor's evaluates the impact the statute may have on the availability of funds to pay investors of its rated securities. In its review of both the original GFLA (effective October 1, 2002) and the amended GFLA (effective March 7, 2003), Standard & Poor's followed its general approach set forth in its recently published article on evaluating predatory lending statutes (for a discussion of Standard & Poor's general approach to evaluating predatory lending statutes, see "Evaluating Predatory Lending Laws: Standard & Poor's Explains its Approach," published on Ratings Direct on April 15, 2003; for Standard & Poor's criteria for loans governed by the original and amended GFLA, see "Standard & Poor's to Disallow Georgia Fair Lending Act Loans," published on Ratings Direct on January 16, 2003, and "Standard & Poor's Will Admit Georgia Mortgage Loans Into Rated Structured Finance Transactions," published on Ratings Direct on March 11, 2003, respectively.)

Section 3 of the Order explicitly preempts the assignee liability provisions of the GFLA for actions or omissions in the origination of a mortgage loan by a national bank or operating subsidiary of a national bank. Based on this explicit preemption language, case law, the National Bank Act (12 U.S.C. §§ 21et seq.) and related regulations (12 U.S.C. §§ 1 et seq.), as well as information received by Standard & Poor's from the OCC, Standard & Poor's believes it has sufficient legal comfort to revise its criteria as follows.

First, loans originated by national banks and their operating subsidiaries under the original GFLA (from October 1, 2002 through March 6, 2003) may now be included in Standard & Poor's rated transactions. For Standard & Poor's to rate transactions that include these loans, Standard & Poor's will continue to rely on the representation and warranty that the loans included in the pool were originated in compliance with all applicable laws, including but not limited to, all applicable anti-predatory and abusive lending laws (Compliance Representation). In addition, Standard & Poor's will require legal comfort in the form of an officer's certificate to the effect that the originator of the loans is a national bank or an operating subsidiary of a national bank, as defined in 12 C.F.R. § 5.3(j) and 12 C.F.R. § 5.34 respectively.

Second, loans originated by national banks and their operating subsidiaries under the amended GFLA (on or after March 7, 2003) (including High-Cost Home Loans, as defined in the amended GFLA) will continue to be permitted in Standard & Poor's rated transactions. For Standard & Poor's to rate transactions that include these loans, Standard & Poor's will continue to rely on the Compliance Representation. In addition, Standard & Poor's will require legal comfort in the form of an officer's certificate to the effect that the originator of the loans is a national bank or an operating subsidiary of a national back, as defined in 12 C.F.R. § 5.3(j) and 12 C.F.R. § 5.34 respectively.

With regard to Georgia state chartered banks and their subsidiaries, on August 5, 2003, the Georgia Department of Banking and Finance issued a Declaratory Ruling to the effect that, as of March 7, 2003, the amended GFLA shall not apply to Georgia state chartered banks and their subsidiaries. Based on this Declaratory Ruling, loans originated by Georgia state chartered banks and their subsidiaries under the amended GFLA (including High-Cost Home Loans, as defined in the amended GFLA) will continue to be permitted in Standard & Poor's rated transactions. For Standard & Poor's to rate transactions that include these loans, Standard & Poor's will continue to rely on the Compliance Representation. In addition, Standard & Poor's will require legal comfort in the form of an officer's certificate to the effect that the originator of the loans is a Georgia state chartered bank or a subsidiary of a Georgia state chartered bank, as defined in Ga. Stat. § 7-1-4.

For entities that are neither national banks (or their operating subsidiaries) nor Georgia state chartered banks (or their subsidiaries), Standard & Poor's will continue to apply its High-Cost Home Loan criteria to loans originated in Georgia, as set forth in its release dated March 11, 2003, as cited above.

In addition to the Order, on July 31, 2003, the OCC proposed a new regulation (Proposed Rule) on the issue as to whether and to what extent Federal law preempts all state law in the area of real estate lending. The Proposed Rule is subject to a comment period. Standard & Poor's will announce its position following the issuance of a final rule.

In addition to the OCC Order and Proposed Rule, the Office of Thrift Supervision (OTS) has also issued pronouncements on preemption of certain state anti-predatory lending laws which are currently being reviewed by Standard & Poor's. Upon completion of its review, Standard & Poor's will publish its position on the OTS pronouncements.

Standard & Poor's regularly reviews its criteria to keep current with changes in the law in the area of predatory lending. These criteria are not stagnant, but evolve over time. Standard & Poor's will continue to publish its criteria to keep market participants informed of any new approaches in this area.

Members of the media may contact Adam Tempkin, Media Relations Manager, at 212-438-7530 or adam_tempkin@standardandpoors.com.

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Research:

Anti-Predatory Lending Laws Assume a Prominent Role in the U.S. RMBS Market

Publication date: 07-Oct-2003
Credit Analyst: Natalie Abrams, Esq. , New York (1) 212-438-6607; Maureen Coleman, Esq. , New York (1) 212-438-6626; Susan E Barnes, New York (1) 212-438-2394

Increased access to mortgage loans has led to increased home ownership across the U.S. While this growth in home ownership is positive, it has become evident that some of this increase has unfortunately occurred simultaneously with a rise in predatory lending practices. Among others, these predatory practices include the following: charging excessive interest or fees; making a loan to a borrower that is beyond the borrower's financial ability to repay; charging excessive prepayment penalties; encouraging a borrower to refinance a loan notwithstanding the lack of benefit to the borrower; and increasing interest rates upon default.

To protect borrowers from unfair, abusive, and deceptive lending practices, the U.S. government and numerous state and local governmental bodies have enacted anti-predatory lending statutes. Typical statutes include provisions that:

- Limit the interest rates and fees that a lender may charge;
- Preclude lending to borrowers without regard to their ability to repay;
- Require refinance loans to provide a net tangible financial benefit to the borrower;
- Prohibit excessive prepayment penalties and balloon payments;
- Require disclosure to the borrower of various loan provisions; and
- Require counseling for borrowers who are planning to take out certain loans that are governed by these laws.

Internationally, governments are also focusing on the same issue. For example, the U.K Department of Trade and Industry announced that a radical overhaul of the U.K.'s credit laws will be brought forward in late 2003. This overhaul will be aimed at clamping down on loan sharking, magnifying the small print of loan agreements, and putting a stop to irresponsible lending. Among other effects, the changes to the law are expected to allow consumers to exit unfavorable credit deals without fear of excessive charges, and increase the transparency of rules related to the early termination of credit agreements.

Although anti-predatory lending statutes in the U.S. are designed to protect borrowers from predatory lending practices, the statutes may also have the negative effect of reducing the availability of funds to such borrowers. First, a lender might reduce its lending in a given state to protect itself from being found in violation of the state's anti-predatory lending statute. Second, a lender might reduce its business because the cost of lending in accordance with a statute's provisions might be uneconomical. Third, a lender might reduce its activities within a given state if the market for the sale of loans made within the state is effectively eliminated. This would occur, for example, if an anti-predatory lending statute imposes liability on purchasers or assignees of loans governed by the statute and potential purchasers and assignees thus reduce their purchasing to avoid liability under the statute.

In addition to possibly reducing the availability of funds to borrowers intended to be protected by anti-predatory lending statutes, these statutes might reduce the availability of funds to pay investors in securities backed by mortgage loans made in the relevant states. (Indeed, given the expansion of individual investments in securities through various retirement and pension plans, these investors might actually be the very same borrowers the statutes are intended to protect.) Reduction in the availability of funds to pay investors in MBS might occur if an anti-predatory lending statute imposes liability on purchasers or assignees of mortgage loans (assignee liability) for holding loans that violate a statute (predatory loans), even if the purchaser or assignee did not itself engage in predatory lending practices.

Therefore, in performing a credit analysis of structured transactions backed by residential mortgage loans, Standard & Poor's Ratings Services evaluates the impact an anti-predatory lending statute might have on the availability of funds to pay investors in the rated securities.

In performing this evaluation, the two most important factors that Standard & Poor's considers are whether an anti-predatory lending statute provides for assignee liability and, if so, what penalties the statute imposes on assignees for holding predatory loans.

Standard & Poor's defines assignee liability as liability that attaches to a purchaser simply by virtue of holding a predatory loan. If Standard & Poor's determines that there is no assignee liability, Standard & Poor's will generally permit loans covered by the statute to be included in rated transactions. If, on the other hand, a given state's anti-predatory lending statute does permit assignee liability, Standard & Poor's will evaluate the penalties under the statute. If damages imposed on purchasers are not limited to a determinable dollar amount, that is, the damages are not capped, Standard & Poor's will not be able to size the potential liability into its credit analysis. Therefore, these loans cannot be included in rated transactions. If, on the other hand, monetary damages are capped, Standard & Poor's will be able to size in its credit analysis the potential monetary impact of violating the statute. Standard & Poor's looks at all types of potential monetary damages, including statutory, actual, and punitive damages. Even if capped damages can be sized, it may not be economical for a lender to make such loans if the credit enhancement required might equal or exceed the monetary value of the loan. For example, if a statute provides for punitive damages (even if these damages are capped), the amount of the damages may well exceed the loan value.

In rating a transaction, Standard & Poor's will also review both a seller's compliance procedures (to determine if they are effective to identify which loans are subject to assignee liability and which loans are predatory) and a seller's creditworthiness (to determine if a seller is willing and financially able to repurchase any predatory loan for a purchase price that would make a securitization trust whole for any costs incurred in connection with the predatory loan). These factors assume increased significance in transactions in which the seller proposes to include loans with assignee liability.

Standard & Poor's has stated that, as a public policy matter, it is in favor of statutes that attempt to curb predatory lending. Standard & Poor's also acknowledges, however, that its role is to evaluate the credit risk to investors associated with anti-predatory lending legislation and not to recommend public policy. The making of public policy is the responsibility of elected officials.

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Research:

Standard & Poor's Clarifies Covered Home Loan Criteria Under NJ State Predatory Lending Law

Publication date: 08-Oct-2003

Credit Analyst: Natalie Abrams, Esq. , New York (1) 212-438-6607; Maureen Coleman, Esq. , New York (1) 212-438-6626

NEW YORK (Standard & Poor's) Oct. 8, 2003--Under the New Jersey Home Ownership Security Act of 2002, a Covered Home Loan can be in violation of the Act only if the creditor making the Covered Home Loan engages in the practice of flipping, as defined in the Act. Because flipping occurs only in the context of a refinancing of a loan, Standard & Poor's will permit Covered Home Loans that are purchase money loans in its rated transactions, provided these loans do not meet the definition of High-Cost Home Loans or Manufactured Housing Loans under the Act.

Standard & Poor's regularly reviews its criteria to keep current with changes in the law in the area of predatory lending. These criteria are not stagnant, but evolve over time. With respect to the Act, Standard & Poor's is currently reviewing the recent opinion letter by the Office of Thrift Supervision and the proposed regulation by the Office of the Comptroller of the Currency, each in connection with preemption matters, as well as the bulletin released by the New Jersey Department of Banking and Insurance. Standard & Poor's will continue to publish its criteria to keep market participants informed of any new approaches in this area.

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[08-Oct-2003] S&P Report Details Impact of Anti-Predatory Lending Laws in U.S. RMB... Page 1 of 2

STANDARD &POOR'S	RATINGSDIRECT

Research:

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S&P Report Details Impact of Anti-Predatory Lending Laws in U.S. RMBS Market

Publication date: 08-Oct-2003

Credit Analyst: Natalie Abrams, Esq., New York (1) 212-438-6607; Maureen Coleman, Esq., New York (1) 212-438-6626; Susan E Barnes, New York (1) 212-438-2394

NEW YORK (Standard & Poor's) Oct. 8, 2003--Standard & Poor's Ratings Services continues to be at the forefront of evaluating the impact that anti-predatory lending statutes might have on the availability of funds to pay investors in certain mortgage-backed securities, and has recently published an article detailing both the genesis of predatory lending practices and the factors that Standard & Poor's considers as part of its routine credit and legal analysis.

The report, titled "Anti-Predatory Lending Laws Assume a Prominent Role in the U.S. RMBS Market," notes that although anti-predatory lending statutes in the U.S. are designed to protect borrowers from predatory lending practices, the statutes may also have the negative effect of reducing the availability of funds to such borrowers. Additionally, the statutes might reduce the availability of funds to pay investors in securities backed by mortgage loans made in the relevant states. "Reduction in the availability of funds to pay investors in MBS might occur if an anti-predatory lending statute imposes liability on purchasers or assignees of mortgage loans (assignee liability) for holding loans that violate a statute (predatory loans), even if a purchaser or assignee did not itself engage in predatory lending practices," wrote Natalie Abrams, Esq., assistant general counsel for Standard & Poor's. "In performing its evaluation, the two most important factors that Standard & Poor's considers are whether an anti-predatory lending statute provides for assignee liability and, if so, what penalties the statute imposes on assignees for holding predatory loans."

According to the report, Standard & Poor's defines assignee liability as liability that attaches to a purchaser simply by virtue of holding a predatory loan. In rating a transaction, Standard & Poor's will also review both a seller's compliance procedures and a seller's creditworthiness. These factors assume increased significance in transactions in which the seller proposes to include loans with assignee liability.

Over the last few years, increased access to mortgage loans has led to increased home ownership across the U.S. While this growth in home ownership is positive, it is evident that the increase has unfortunately occurred simultaneously with a rise in predatory lending practices. Among others, these predatory practices include the following: charging excessive interest or fees; making a loan to a borrower that is beyond the borrower's financial ability to repay; charging excessive prepayment penalties; encouraging a borrower to refinance a loan notwithstanding the lack of benefit to the borrower; and increasing interest rates upon default.

Standard & Poor's has stated that, as a public policy matter, it is in favor of statutes that attempt to curb predatory lending. Standard & Poor's also acknowledges, however, that its role is to evaluate the credit risk to investors associated with anti-predatory lending legislation and not to recommend public policy. The making of public policy is the responsibility of elected officials.

"Anti-Predatory Lending Laws Assume a Prominent Role in the U.S. RMBS Market" is available on RatingsDirect, Standard & Poor's Web-based credit analysis system, at www.ratingsdirect.com. The article is also available on Standard & Poor's Web site, at www.standardandpoors.com. Select Credit

Ratings, then under Browse by Business Line, select Structured Finance and locate the article, dated Oct. 8, 2003, under Commentary & News.

Testimony

before the

Subcommittee on Housing and Community Opportunity
and
Subcommittee on Financial Institutions and Consumer Credit
at Joint Hearing regarding

"Protecting Homeowners: Preventing Abusive Lending While Preserving Access to Credit"

November 5, 2003

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on behalf of
Low income clients of the National Consumer Law Center
National Association of Consumer Advocates

Testimony
before the
Subcommittee on Housing and Community Opportunity
Subcommittee on Financial Institutions and Consumer Credit
regarding
"Protecting Homeowners: Preventing Abusive Lending While Preserving Access to Credit"

Chairman Ney and Mrs. Waters, Chairman Bachaus and Mr. Sanders, and members of both subcommittees, we thank you for inviting us to testify today regarding the need to protect homeowners from abusive credit. I testify here today on behalf of the low income clients of the **National Consumer Law Center**[1], as well as the **National Association of Consumer Advocates** and the **U.S. Public Interest Research Group.**[2] The clients and constituencies of these legal services programs and consumer groups collectively encompass a broad range of families and households who have been affected by predatory lending.

The issues that you are requesting input on today are complicated and controversial. There are three, distinct and diverse interests in this debate –

- the **homeowners** (and their representatives), who want the rules changed to eliminate, or at least reduce, predatory lending;
- the **originators** of subprime mortgage loans, who have a profitable market in the current legal structure, and who want to be able to continue in this profitable endeavor;
- the **secondary market,** who is generally not directly involved in the making of

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[1]The **National Consumer Law Center,** Inc. (NCLC) is a non-profit Massachusetts Corporation, founded in 1969, specializing in low-income consumer issues, with an emphasis on consumer credit. On a daily basis, NCLC provides legal and technical consulting and assistance on consumer law issues to legal services, government, and private attorneys representing low-income consumers across the country. NCLC publishes a series of sixteen practice treatises and annual supplements on consumer credit laws, including Truth In Lending, (4th ed. 1999) and Cost of Credit (2nd ed. 2000) and Repossessions and Foreclosures (4th ed. 1999) as well as bimonthly newsletters on a range of topics related to consumer credit issues and low-income consumers. NCLC became aware of predatory mortgage lending practices in the latter part of the 1980's, when the problem began to surface in earnest. Since that time, NCLC's staff has written and advocated extensively on the topic, conducted training for thousands of legal services and private attorneys on the law and litigation strategies to defend against such loans, and provided extensive oral and written testimony to numerous Congressional committees on the topic. NCLC's attorneys were closely involved with the enactment of the Home Ownership and Equity Protection Act in Congress, and the initial and subsequent rules pursuant to that Act. NCLC attorneys, on behalf of their low income clients, have actively participated with industry, the Federal Reserve Board, Treasury, and HUD in extensive discussions about how to address predatory lending.

[2]The **National Association of Consumer Advocates** (NACA) is a non-profit corporation whose members are private and public sector attorneys, legal services attorneys, law professors, and law students, whose primary focus involves the protection and representation of consumers. NACA's mission is to promote justice for all consumers.

The **U.S. Public Interest Research Group** is the national lobbying office for state PIRGs, which are non-profit, non-partisan consumer advocacy groups with half a million citizen members around the country.

predatory loans,[3] but which is making a lot of money by securitizing subprime loan mortgages.

Each of these parties has a different perspective on the way that the issue of predatory mortgage lending is resolved, but one thing is clear – an truly effective resolution cannot make all parties happy. The problem of predatory lending cannot be addressed without pinching the interests of either the originators or the secondary or market, or both.

We provide our answer to the question posed by the Committees in the following parts of this testimony:

I. The Problem to be Addressed – Stopping Predatory Lending, *Not* Preserving Access to Credit.
II. Necessary Steps to Address Predatory Mortgage Lending.
III. The Importance of Assignee Liability.

I. The Problem to be Addressed – Stopping Predatory Lending, *Not* Preserving Access to Credit

The question to be addressed by witnesses in this hearing is:

> "The Subcommittees are particularly interested in possible solutions, implemented both in the origination process and in the secondary market for subprime mortgage loans, designed to eliminate abusive lending practices while also preserving and promoting access for consumers to affordable credit."

We believe that when addressing the problem of predatory mortgage lending, the emphasis should be on *stopping the problem, not preserving access to credit.* Preserving access to credit is *not* the problem in today's market. There is so much access to credit that American consumers are overwhelmed by it, and harmed by it. Too much credit is not a good thing. Too much credit drives loss of equity, bankruptcies, insolvencies, and foreclosure. Too much credit only benefits the creditors -- not the consumers.

In the early 1980s, this nation did face a crisis of affordable credit, and it was necessary to change the laws to deal with this problem. Laws were changed, starting with the 1980 passage of the Depository Institution Deregulation and Monetary Control Act ("DIDMCA") and the

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[3]It should be kept in mind that at least one large player in the secondary market for subprime loans – Lehman Brothers -- has been found by a jury to be *directly* involved in and responsible for millions of dollars of predatory loans. *In re First Alliance Mortg. Co.* 298 B.R. 652 , (C.D.Cal., Jul 30, 2003).

Alternative Mortgage Transaction Parity Act ("AMTPA"), passed in 1982.[4] The intent of both of these laws was to loosen the effects of state limits on interest rates and loan terms which were temporarily strangling access to credit necessary to achieve homeownership. These two laws preempted state consumer credit protection laws applicable to mortgages, unless the individual states acted within a short time frame to preserve the ability to govern the interest rates for first mortgage loans, and the terms for alternative credit products. Only a small minority of states were able to act quickly enough to maintain this prerogative.[5] The net effect of these two federal lawspassed in the early 1980s to address the real credit crunch of the time was to remove from most states their historic ability to set interest rate ceilings on first mortgage loans and limits on alternative mortgage lending.

Now, in the early years of the Twenty First Century, the problem is that too much credit is not just available, but is being pushed on consumers.[6] In fact, the success of the secondary market's ability to provide plentiful money to originators of subprime loans has created its own momentum for the continued escalation of subprime lending. In other words, the fact that money is available to be lent in the subprime mortgage market has *pushed* more loans than the borrowers themselves have needed. The driving force behind many subprime mortgages is *not* the need of the borrower to refinance a mortgage, it is the need of the originator and the secondary market to fill a securitization. In a typical securitization, the money is provided by the secondary market, and the commitment to make loans for this total amount of money is made *before* the loans are made to individual borrowers.

Thus, the subprime market is a *push market.* The driving forces for much of the lending are not the borrowing needs of the homeowners, but the securitization needs of the originators and the investors. That is what is causing much of the problems of predatory lending – incentives are built into the system to make loans, even when they won't perform. The loans must be made to fill the securitization commitments, and if there are problems with the performance of the loans, these can simply be addressed by refinancing the loan. The successive refinancings deplete the equity in the homes, until finally the homeowner is driven to foreclosure. But only the last loan in the series appears to be flawed, only the one which does end in foreclosure. The previous loans, all of which were probably just as over priced and unnecessary as the last one, appeared to be performing loans, because they were paid off by refinancing.

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[4]*See* Cathy Lesser Mansfield, *The Road to Subprime "Hel" was Paved with Good Congressional Intentions: Usury Deregulation and the Subprime Home Equity Market,* 51 S.C.L. Rev. 473 (2000).

[5]The following fourteen states preserved their ability to regulate interest rates for first mortgage loans: Colorado, Georgia, Hawaii, Idaho, Iowa, Kansas, Maine, Massachusetts, Minnesota, Nebraska, Nevada, North Carolina, South Carolina, Wisconsin. Only six states preserved their ability to regulate alternative mortgage transactions. Arizona, Maine, Massachusetts, New York, South Carolina, and Wisonsin.

[6]Ira Goldstein, *Predatory Lending: An Approach to Understand and Identify Predatory Lending,* The Reinvestment Fund, http://www.trfund.com/policy/FordForWeb.pdf.

To address predatory lending, we must first recognize there is a push market and that it must be stopped. Money should be available for subprime lending, but it need not be available in the current quantities. To change this dynamic some significant changes to the laws of this nation must be made.

The 1990s saw the phenomenal growth in the use of asset-based securities to fund an ever increasing supply of mortgage credit.[7] Creating capital flow in this way for subprime mortgage lenders took off following 1994. In that year, approximately $10 billion worth of home equity loans were securitized.[8] By the end of 1997, the volume had leaped to about $90 billion.[9]

While subprime mortgage lending has escalated dramatically, there has not been a similar increase in the rise in homeownership. Homeownership has only increased in the past 20 years from 64.8% of American households in 1982, to 67.9% in 2002[10] an increase of 4.8%. Subprime mortgage lending instead has largely been a *mistaken* way that American households have handled their debt problems. The result has been a huge increase in the number of subprime mortgages made, a huge *reduction* in the amount of home equity Americans have accumulated, and an ever escalating increase in the number of foreclosures of subprime mortgages. Each one of these problems present separate, and damaging, stories for American families.

Wrong Message Sent by the Tax Code. In 1986, Congress changed the tax code to allow taxpayers to deduct the interest for consumer loans only if the loan is secured by the home. This allowed the lending industry to sell their product by promoting the message to homeowners that borrowing against home equity is sensible economic planning. Unfortunately, this is quite often incorrect, even for middle income families. For low income households, this tax deduction is generally of no benefit because the working poor have little or no tax liability because of the earned income tax credit. Others are paying at the tax system's lowest tax rates.

One consequence of limiting deduction of consumer debts to home equity loans is that many Americans are now paying much more interest on consumer debt, albeit generally at a lower rate per year. This is largely due to a lack of understanding and appreciation for the costs of financing debt over an extended period of time.

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[7] *The Asset-Back Securities Market: The Effects of Weakened Consumer Loan Qualtiy*, FDIC Regional Outlook, Second Quarter, 1997.

[8] Daniel Immergluck & Marti Wiles, *Two Steps Back: The Dual Mortgage Market, Predatory Lending , and the Undoing of Community Development*, at 12, Woodstock Institute (Nov. 1999).

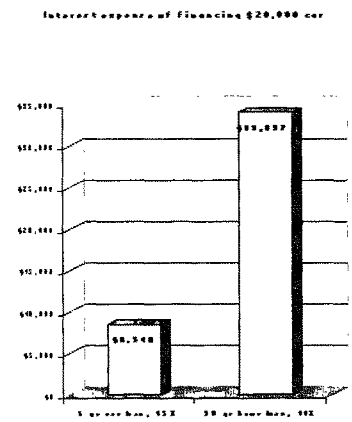
[9] Glenn B. Canner, Thomas A. Durkin & Charles A. Luckett, *Recent Developments in Home Equity Lending*, 84 Fed. Res. Bull. 241, 250 (April 1998). *See also* U.S. Census Bureau, Statistical Abstract of the United States: 1999, Table No. 820 (this table reveals that by 1998, $411 billion of mortgage loans were held by private mortgage conduits, including securitized loans; table does not distinguish between prime and subprime lenders, however.

[10] U.S.Census Bureau *Housing Vacancies and Homeownership Annual Statistics: 2002*, Table 12.

Generally, families are persuaded to pay off car loans, credit cards, and other non-housing related expenses with loans secured by their homes because of the perceived tax savings generated by the deductibility of interest related to home secured debt. This perception of savings is generally misplaced; because while the actual rate of interest is lower, the money is lent for a much greater length of time, resulting in a much higher cost to the homeowner, even after the tax benefits are considered. For example, consider the following example of a car loan refinanced into a home loan:

- *Car loan paid in installments.* A 5 year loan with an interest rate of 15% for $20,000, will have a **total interest expense on the loan of $8,548.**

- *Car loan refinanced into home equity loan.* A 30 year home loan for the same amount at an 11% interest rate effectively *costs* the homeowner more than four times as much in extra interest – even after counting the tax benefits. Just the interest charges on $20,000 over 30 years will be $48,567. Even if tax savings compensate for 30% of the interest expenses, the net cost of financing the car over the life of home mortgage is still 70% of $48,567 or **$33,997.**[11]



Depletion of Home Equity. A more serious consequence is the increase in the loss of equity for American households.[12] Even as the ratio of debt to savings for American families has risen over the past twenty years, the ratio of home equity debt to other debts has increased at a much

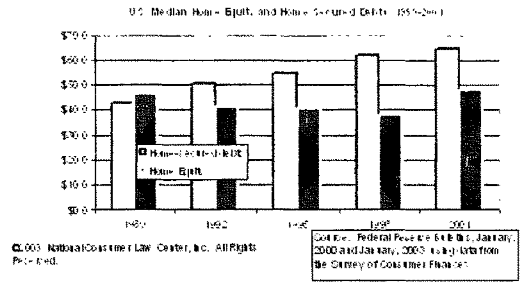
[11]Even when the *present value calculations* are applied to both the five year car loan and the 30 year home loan, the comparison between the interest for the car loan to the total paid in interest *after tax deductions* for the home loan reveals that the 30 year home loan with the lower interest rate and the tax deductions is still almost three times as expensive as the five year car loan.

[12]Home equity is the difference between the value of the home and the loan amount. For example, a home with a value of $100,000 and an outstanding balance of the mortgage secured by the home of $60,000, would have home equity of $40,000.

greater pace.[13] This has several consequences:

- U.S. families are *switching* much of their debt from installment or credit card loans to home secured loans.

- This has the consequence of significantly reducing home equity savings for these households – and home equity saving has long been the traditional method of building assets for American families.



Consider the above chart, which shows the dramatic *increase* in home secured debt in the past decade, as well as the relative *decrease* in home equity. This bleeding of home equity causes a general diminution of the wealth and security of millions of American families.

Add this loss of equity to the escalating bankruptcies and insolvencies in this nation, and it becomes clear that the problem is not lack of access to credit, but too much access to the wrong kind of credit. In 2003, there were over 1.5 million bankruptcies, increasing again from the previous year.[14] But the number of bankruptcies filed by American households does not begin to tell the full story. Household debt is at a record high relative to disposable income.[15] Many families are too poor to file bankruptcy – we estimate that there are millions more people who are flat broke – too poor to file bankruptcy.

Foreclosures are skyrocketing, harming families and their communities. When compared to any other relevant measure – increase in homeownership, increase in number of mortgage loans, even the ratio of foreclosures per mortgage – the rate and number of foreclosures is escalating at an alarming pace in this nation. The blame for this dramatic increase in foreclosures can be laid squarely at the doorstep of the subprime mortgage market, with its 8% foreclosure

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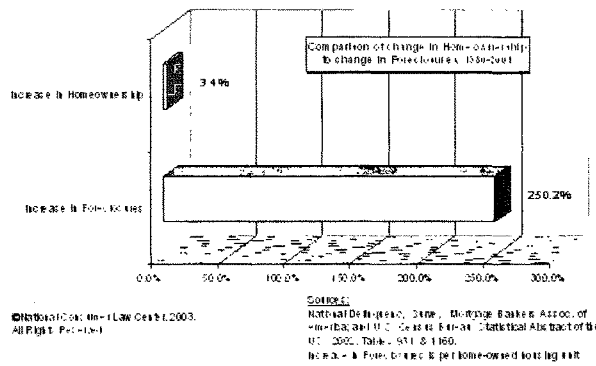
[13]Federal Reserve Bulletins, 2000 and 2001, using data from the Survey of Consumer Finances.

[14]American Bankruptcy Institute, http://www.abiworld.org/stats/newstatsfront.html.

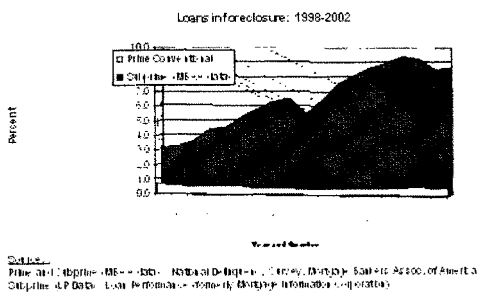
[15]*Id.*

rate,[16] which has reached 12% or higher in some states.[17]



The escalating foreclosures in this nation are the fault of the subprime mortgage market. While the ratio of foreclosures to loans made has remained fairly steady over the years for the prime mortgage market, the same cannot be said for the subprime mortgage industry. In the prime mortgage industry, only 1 in 100 mortgages will go to foreclosure. In the subprime industry, the ratio is 1 in 12.

As Harvard Law Professor Elizabeth Warren recently pointed out – when comparing the degree of regulation in this nation for credit to other dangerous products – it would never be acceptable for a toaster to be sold which has a 1 in 12 chance of



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[16]Prime and Subprime (MBAA data): National Delinquency Survey, Mortgage Bankers Assoc. of America, Subprime (LP Data): Loan Performance (formerly Mortgage Information Corporation) www.loanperformance.com.

[17]*Id.*

blowing up.[18] Why therefore should it be considered acceptable for an industry to exist which markets a product with an 8% expectation of failure? Yet this is exactly the failure rate of our subprime mortgage industry. The fact that the laws of this nation permit this is an indication that our policies to foster homeownership are being seriously undermined by the practices of the subprime mortgage industry. Something has to change – there must be a basic recognition by the policymakers that unbridled credit is not helping America, it is not helping our communities, and it is actively hurting millions of American families.

By focusing on the subprime mortgage industry, it is not our intent to say that all subprime mortgages are bad, or that the entire industry provides predatory loans. Our goal is only to point out that a necessary objective of any laws designed to address predatory lending in a meaningful way *must* include the recognition that the effect of those laws will be to cut back on a sizeable portion of those mortgages which result in a) an unnecessary loss of equity for homeowners, and b) too high a risk of foreclosure. There is no reason that it should be considered acceptable for the foreclosure for subprime mortgages to be eight times the rate for prime mortgages. A 200% higher risk of foreclosure, as compared to prime mortgages – with its concomitant devastating consequences for the homeowner, the family and the community – should be the maximum which is acceptable.

II. Necessary Steps to Address Predatory Mortgage Lending

Enforcement of Existing Laws Will *Not* Stop Predatory Lending. It is not at all difficult to name the predatory characteristics of a predatory mortgage loan. There is no doubt that some of the problem in the marketplace can be traced to outright fraud and unfair or deceptive acts and practices, which are already illegal under many state laws.[19] However, many of the standard predatory characteristics of problem mortgage loans are perfectly legal under the current regime of federal, and most state, laws.

Law enforcement is an important tool in the battle against predatory lending if it specifically addresses abusive practices used by many subprime lenders and ensures that borrowers have effective remedies. Misleading homeowners about the true costs of loans, charging more than was agreed to by the homeowner, tricking homeowners into agreeing to loans with unaffordable payments, and misstating the homeowner's household income on loan

[18]Elizabeth Warren & Amelia Warren Tyagi, *The Two Income Trap: Why Middle Class Mothers and Fathers are Going Broke.* 2003, chapter 6.

[19]To be clear – fraud is illegal under every state's common law. However, not every state has comprehensive statutes prohibiting unfair and deceptive activities in mortgage loans. Many state statutes only prohibit deception – unfairness is not addressed. Many state statutes on unfair or deceptive practices either do not cover mortgage transactions or do not cover transactions which are governed in any way by another law. National Consumer Law Center, *Unfair and Deceptive Acts and Practices* (5th ed. 2001), Chapter 2.

There is also some preemption of the application of state statutes on unfairness and deception asserted by the Offices of Thrift Supervision and the Comptroller of the Currency. *See e.g.* OTS Chief Counsel Letter of 2/24/96, and OCC Docket No. 03-16 68 Fed.Reg. 46119 (August 5, 2003).

applications, are all examples of frequent abusive behaviors that violate existing laws, yet require extensive legal resources to prove and obtain redress for the homeowner.

Even significant increases in the enforcement of existing laws would not fully address the problem of predatory mortgage lending. Only real legislative reforms will stop lenders from financing high points and fees, charging exorbitant prepayment penalties, using variable interest rate terms that only go up, refinancing special program mortgages for first time buyers into high cost credit, and similar legal but rapacious behavior. Only by changing the laws governing mortgage lending can we fully address the problem of predatory mortgage lending.

What is a predatory loan? Three of the worst predatory practices involve the charging and financing of high amount of points and fees,[20] heavy prepayment penalties accompanied by higher than par interest rates for those borrowers, and flipping – or repeatedly refinancing the mortgage loan.[21] These practices typically provide the impetus for equity stripping (which results in the reduction or elimination of value of the consumer's major asset) and most rewards the originator and subsequent holders of the loan (through an increase in the principal that is paid immediately to the originator upon sale to the secondary market or that is paid over time to the holder or recouped at foreclosure). The more the borrower is charged up-front, the more the lender and holder achieves a direct financial gain. Prepayment penalties provide additional profit to the holder when the loan is paid off and provide an incentive to flip the customer to trigger this

[20]We include in our definition of fees the high costs of single premium credit insurance.

[21]There are numerous other predatory mortgage loan *indicators*, as set out below. Each must be addressed. But the single most important aspect of predatory lending is the financing of points and fees. Until this part of the problem is directly addressed, predatory lending will continue, without significant reduction of the problem:

- **Credit insurance packing** with high priced pre-paid term credit (life, disability and unemployment) insurance which add thousands of dollars in unnecessary costs to loans for borrowers who could obtain more reasonably priced credit insurance if paid on monthly basis;
- **Mandatory arbitration clauses,** which require the homeowner to arbitrate at considerable expense before arbitrators who have no incentive to follow consumer protection laws, and whose decisions are not reviewable by any court;
- **Spurious open end loans** whereby the lender is allowed to avoid making the more comprehensive disclosures required by closed end credit, and thereby avoid any chance of the homeowner asserting the right of rescission, as well as completely avoiding the restrictions under the Home Ownership and Equity Protection Act, regardless of the cost of the loan;
- **Paying off low interest mortgages** such as purchase money loans with FHA with much higher interest rate loans;
- **Refinancing unsecured debt** for which the borrower could not lose the home, with high interest rate debt which must be paid to avoid foreclosure;
- **Refinancing special no-rate or low rate mortgages** with high cost loans.
- **Yield spread premiums** paid to the broker even when the homeowner has already paid all closing costs, increases the cost of the loan.
- **125% loan to value loans** are predatory for a different reason than the typical predatory loan we most often see in the low-income community. These loans effectively prohibit homeowners from selling their homes or filing bankruptcy to escape unaffordable debt, without losing their home.

income stream.

If the homeowner is unable to continue paying a loan, the lender or holder often refinances to make the loan "performing." However, this just means more profit for the lender since a new round of points and fees are added to the principal, and a prepayment may be collected as well. So long as there is sufficient equity in the home (and there generally is plenty), this lender *benefits* every time the borrower defaults. A default provides the lender with reason to make a new loan, and charge more points and fees. This creates another immediate opportunity to turn a quick profit. Even if the borrower does not default, predatory lenders convince borrowers to refinance their loans and receive a small amount of additional cash, thus taking advantage of the large prepayment penalty typically included in these loans.

Predatory lending is causing the massive loss of both equity and homes because the current legal and economic regime allows – indeed encourages – lending practices which reward lenders for making loans that are unnecessary, are unaffordable, bleed equity, and lead to foreclosure.

The government, as well as the housing and lending industries, has done an excellent job in recent years of expanding programs to establish new homeownership opportunities for low-income families. The next challenge is to enhance the long term sustainability of the homeownership experience for these families. The ultimate success of homeownership as an asset building strategy will be measured by the degree to which new homeowners are able to afford proper maintenance, avoid foreclosures, build equity in their homes, and use their equity effectively as wealth. As should be clear from the discussion in Part I above, the market does not work to protect homeowners from abusive mortgage loans.

In 1994, Congress passed the Home Ownership and Equity Protection Act (HOEPA) to prevent some predatory lending practices after reviewing compelling testimony and evidence presented during a number of hearings that occurred in 1993 and 1994. This law created a special class of regulated closed-end loans made at high rates or with excessive costs and fees. Rather than cap interest rates, points, or other costs for those loans, the protections essentially prohibit or limit certain abusive loan terms and require additional disclosures. HOEPA's provisions are triggered if a loan has an APR of 10 points over the Treasury security for the same term as the loan, or points equal to more 8% of the amount borrowed.[22]

It was hoped that HOEPA would reverse the trend of the past decade, which had made predatory home equity lending a growth industry and contributed to the loss of equity and homes for so many Americans. However, by passing HOEPA, Congress has already recognized two essential truths: that there are some loans for which the marketplace does not effectively apply restrictions; and government must step in to provide balance to the bargaining position between borrowers who either lack the sophistication to avoid bad loans or do not believe they have a

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[22] 15 U.S.C. § 1602(AA)(1)(B).

choice if they want the credit. Unfortunately it is clear that HOEPA has not stopped predatory lending. Indeed, the problem has only grown worse in the eight years since it has become effective.

The Shape of Reform. A key facet to resolving the problem of predatory lending is the limitation on the financing of points and closing costs. Loans covered would be prohibited from financing all but a very few number of points and closing costs. Ideally, we would make this number zero, with the only exception for *bona fide* discount points used to buy down the loan rate in a legitimate way.[23] This would require that the lender pay all of the costs of closing the loan from the proceeds of the loan, including the broker fees, and recoup them through the interest payments on the loan.[24] While the rate of interest charged the borrower will increase slightly, the up-front fees will be brought to 0. If the borrower desires *to buy down* the loan rate by directly paying points, the borrower can do so in a seamless, transparent exchange – lower interest rate in exchange for a certain number of points. The confusion and lack of transparency that typifies the current closing process would be eliminated. More importantly many of the driving forces behind the making of a predatory loan would no longer exist.[25]

There are a multitude of clear benefits which would flow from a strict requirement that only *bona fide* discount points be permitted to be charged to the borrower at a loan closing:

- Less equity will be stripped from the home. The amount of money that the borrower owes interest on will be much closer to the amount which benefits the borrower. Every payment the borrower makes will reduce the loan amount. Even if there are repeated refinancings, the loan amount will not rise, unless the borrower is receiving cash out. The equity in the home is no longer the source of financing the loan – the loan can only be financed through the borrower's income.

- The lender will have the incentive to make these loans affordable. Currently, a typical predatory mortgage transaction creates thousands of dollars of immediate profit to the lender upon sale of the loan to an investor. Under the current system, when the borrower refinances the loan, the lender sees a substantial profit, providing an incentive to the lender to encourage refinancings, regardless of whether the borrower can actually afford to repay

[23] We acknowledge that political realities may force the percentage of permitted fees to be greater than zero, but the logic of the analysis is best illustrated with zero points and fees (excluding *bona fide* points) allowed.

[24] Borrowers would still pay fees for services and products which they choose to purchase which are not required by the lender for the closing of the loan – homeowner's title, home inspection, their own attorney to review the transaction, etc.

[25] We acknowledge that this proposal will be wildly unpopular with many in the settlement services industry (as is evident from the response to HUD's proposal on RESPA). It is also essential to recognize that our proposal is significantly different from HUD's in that it would involve a change in the *law*, rather than simply regulations, such there would not be the serious problems which will flow from HUD's current proposal with determining compliance with the Truth in Lending Act.

the refinanced loan. Yet, if the lender only reaps a benefit from the loan through the *payments* the lender has a clear incentive to make sure that the borrower can afford the payments.

- The market will work to keep the interest rate on these loans competitive. So long as the borrower has not invested a significant amount of money in each loan – as is done when thousands of dollars in points and fees are financed – there is little to stop the borrower from shopping for a lower rate loan when his credit improves, or interest rates fall - just as is done in the prime market. As a result, when the loan is first made, the wise subprime lender will make the rate only high enough to cover the costs, the real risk, and a reasonable profit. If more is charged, the borrower will be able to refinance at a lower rate with a competitor.

- The cost of the loans will be transparent – even to the *least sophisticated* consumer. The complexity in today's mortgage shopping flows from the indecipherable combination of interest points and *some* fees, not all of which are included in the finance charge, and thus in the annual percentage rate.[26] If all costs to close the loan are paid by the lender and the only measurement of the loan's cost is the interest rate – except when the borrower chooses to pay *bona fide* discount points – even the least sophisticated consumer can tell that a loan with an interest rate of 9% is less expensive than a loan with an interest rate of 10%. But who among even sophisticated consumers can actually decipher the better deal between a 9% loan with 6 points and $4,000 in closing costs, as compared to a 10% loan with 2 points and $3,000 in closing costs and a prepayment penalty?

- With limits on prepayment penalties, no usury cap would be required. It has been said that the reason for prepayment penalties in subprime loans is due to the faster refinancing of these loans.[27] Indeed subprime loans are generally refinanced sooner than prime loans, however, this is because the push market in the subprime industry drives this refinancing.[28] However, if subprime loans were actually more competitive, and originators no longer had the incentive of the fast profit from the loan origination process itself, there would be no reason for subprime loans to refinance at a faster pace than those in the prime market. Thus the current arguments supporting prepayment penalties in the subprime market would no longer be applicable – and prepayment penalties would only be appropriate in

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[26]Under the Truth in Lending Act, the annual percentage rate includes the interest charged on the loan, all points, all broker fees, and only some of the fees charged for closing a home mortgage loan. 15 U.S.C. § 1605(e), 12 C.F.R. § 226..4(c)(7). This inclusion of some, but not all, fees leads to an imperfect and litigation inviting calculation of the finance charge. The question of which fees should be included and which fees excluded from the finance charge is the most litigated issue under both HOEPA and the Truth in Lending Act.

[27]Eric Stein, *Quantifying the Cost of Predatory Lending*, Coalition for Responsible Lending, July 25, 2001 at 9. http www.predatorylending.org pdfs/Quant10-01.PDF.

[28]*Id.*

situations where they were legitimately exchanged for a *bona fide* reduction in the interest rate. As a result, real limits on the amount of prepayment penalties and the time within which they can be charged on a loan would be appropriate. With these two protections – strict limits on 1) points and fees and 2) prepayment penalties – no usury cap would be necessary, because the market actually might work in a competitive manner even for subprime borrowers.

- Liability issues would be clear and TILA litigation issues would be reduced significantly. Most of the actual and feared litigation under the Truth in Lending Act surround the issue of whether fees are justifiably excluded from the finance charge.[29] Almost all of the litigation under HOEPA regards the issue of whether a loan is properly considered *not* to be a HOEPA loan based on the lender's calculation of the fees included in the points and fees trigger for HOEPA loans.[30] With all of these fees paid by the lender and already included in the interest rate – all of this confusion and potential litigation evaporates.

III. The Importance of Assignee Liability.

Background. In order to obtain cash to fund their operations, and to limit the risk associated with the extension of credit, many creditors sell obligations that they receive from borrowers to third party creditors who may or not have had connection with the original credit transaction. This pattern of financing retail credit through a secondary market prevails in both commercial and consumer transactions and has been encouraged by the Uniform Commercial Code ("UCC"). One of the primary mechanisms to encourage this flow is the holder in due course doctrine, which permits those who purchase "negotiable instruments"[31] to protect themselves from claims of any other parties, and to free themselves from many, but not all, defenses to payment on the instrument.[32] The idea is that an investor can purchase negotiable instruments with limited risks. If an instrument appears valid on its face, the investor does not worry that the instrument might have been stolen, or that the maker of the instrument (*e.g.* the borrower) might

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[29]*See generally*, National Consumer Law Center, *Truth in Lending* (4th ed. 1999) § 10.2.4.

[30]15 U.S.C. § 1602 (aa)(4); *see e.g. Cooper v. First Gov't Inv. Corp.* 239 F. Supp.2d 50 (D.D.C. 2002).

[31]Checks and promissory notes are classic examples of instruments which generally fall within the UCC definition of a "negotiable instrument." UCC § 3-104.

[32]UCC § 3-305. Defenses which can be asserted against a holder in due course include the lack of the maker's capacity to execute the instrument, *e.g. Shepard v. First American Mortgage Co.*, 347 S.E.2d 118 (S.C. Ct. App. 1986), duress, the illegality of the instrument, misrepresentation of the essential character or terms of the contract, *American Plan Corp v. Woods*, 240 NE2d 886 (Ohio App. 1968), "fraud that induced the obligor to sign the instrument with neither knowledge nor reasonable opportunity to learn its character or its essential terms," and bankruptcy. UCC § 3-305(a)(1)(, (b). Usury can be a defense to a holder in due course, *see, e.g. Davenport v. Unicapital Corp.* 230 S.E. 2d 905 (S.C.1976), National Consumer Law Center, *The Cost of Credit: Regulation and Legal Challenges* (2d ed. 2000) § 10.6.1.3.2. For a discussion of fraud as a defense to a holder in due course, *see generally, Cost of Credit,* § 11.10.1; *§* Annot. 78 A.L.R.3d 1020 (1977).

have a contract dispute with the original lender, which would justify the maker's refusal to pay on the instrument. So long as the holder qualifies as a holder in due course, its risks are limited to the inherent risks of nonpayment because of the borrower's bankruptcy, etc., and to the possibility that the instrument itself was originally invalid.

The holder doctrine, however, is not absolute, and not all assignees can successfully assert it in response to a consumer claims and defenses. Most importantly, the Holder rule has been severely restricted for many consumer transactions, as the uneven bargaining power and unequal sophistication in these transactions meant the operation of the rule unfairly inflicted great hardships. Thus many state consumer credit *non-mortgage* statutes limit its impact, as does the FTC Preservation of Claims and Defenses Rule in the context of consumer retail sales.[33]

However, the FTC Preservation of Claims and Defenses Rule does not apply to most mortgage transactions.[34] Congress limited the circumstances in which assignees of high cost mortgage loans can assert holder in due course status for HOEPA loans.[35] Moreover, even under traditional UCC doctrine, both the underlying obligation and the assignee must meet UCC definitions of a "negotiable instrument" and "holder in due course," and a failure to meet all the technical elements will deprive the assignee of that status. Finally, certain types of claims and defenses may be asserted even against holders in due course.[36]

Application of the holder in due course doctrine is widely recognized to have been an unmitigated disaster for individual consumer debtors.[37] Take, for example, the situation where homeowners sign a loan and mortgage for home improvements secured by their home. The documents do not include the required FTC Notice of Preservation of Claims and Defenses, and the contact information provided by the home improvement contractor is useless. The home improvement work turns out to be shoddy and useless, but the assignee of the loan claims to have no knowledge of the status of the work, instead claiming it is an innocent third party assignee that

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[33]16 C.F.R. § 433; *see generally* National Consumer Law Center, *Unfair and Deceptive Acts and Practices* § 6.6.3 (5th ed. 2001).

[34]*Id.*

[35]§15 U.S.C. § 1641(d).

[36]Common law theories of participation, ratification, and acceptance of benefits with knowledge of the fraud can also make an assignee liable for the acts of the originator. *Maberry v. Said*, 927 F. Supp. 1456 (D.Kan.1996); *England v. MIG Investments, Inc.*, 93 F.Supp. 2d 718 (S.D. W.Va. 2000). *See generally* National Consumer Law Center, *The Cost of Credit: Regulation and Legal Challenges* (2d ed. 2000) § 10.6.1.3.

[37]Eggert, Kurt, *Held Up In Due Course: Codification and the Victory of Form Over Intent in Negotiable Instrument Law*, 35 Creighton L. Rev. 363 (Apr. 2002). For a discussion of the many problems that the holder in due course rule posed for consumers, *see* 40 Fed. Reg. 53506 (Nov. 19, 1975 (Statement of Basis and Purpose for adoption of FTC assignee notice requirement). *See also Hearings on Problems in Community Development Banking, Mortgage Lending Discrimination, Reverse Redlining, and Home Equity Lending, Before the Senate Comm. On Banking, Housing and Urban Affairs*, 1st Sess. 103d Cong. (Feb. 3, 17, 24 1993) (S. Hrg. 1030137).

merely wants its monthly payments. When the homeowners refuse to pay, the assignee claims the rights of a holder in due course and begins foreclosure proceedings. The UCC holder rules have at least the potential for taking away the homeowner's legal right to refuse to pay for defective goods and services.[38]

Previous Recognition of Fault of Secondary Market in Predatory Mortgage Lending. When Congress enacted HOEPA in 1994 it recognized that the growth of the secondary market was one of the factors contributing to the "equity skimming" lenders in the 1980s. The unethical contractor or mortgage lender could make an overreaching loan without fearing any consequences, because it received its money, then passes the risk on to the secondary market purchaser. Too many of those purchasers, in turn, do not assure that they are doing business with reputable, ethical originators, since they can use the holder doctrine as a shield to protect themselves from the borrowers' defenses.[39] As a consequence, assignees of HOEPA loans are subject to *all* claims (not just TILA claims) and defenses of the borrower which could have been raised against the originator. However, the assignee's liability that is extended based solely as the result of this HOEPA language is limited to the total paid by the borrower offset against the remaining indebtedness.[40]

To alert buyers of HOEPA loans of the potential liability, HOEPA loans are required to carry a prominent notice. However, the fact that the loan does not include the notice does not relieve the holder of liability. The only way that a holder can avoid the liability associated with a HOEPA loan is to prove by a preponderance of the evidence that it could not, with due care, have determined that a reasonable lender, exercising due diligence after looking at all the relevant documents, could not tell that this was a HOEPA loan.[41]

Any new rules that Congress establishes to address predatory lending must include some reasonable degree of liability for assignees. Without any liability for assignees, consumers are left

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[38]In fact, many courts reviewing such home improvement contracts determined that the finance company purchasing such home improvement contracts have not acted in good faith and without notice of the defenses and were therefore not a holder in due course. *See, e.g. Fin. Credit Corp. v. Williams,* 229 A.2d 712 (Md. 1967); *General Inv. Corp. v. Angelini,* 278 A.2d 193 (N.J. 1971); *see generally* Annot. 36 A.L.R. 4th 212 (1985).

[39]*Hearings on Problems in Community Development Banking, Mortgage Lending Discrimination, Reverse Redlining, and Home Equity Lending, Before the Senate Comm. On Banking, Housing and Urban Affairs,* 1st Sess. 103d Cong. (Feb. 3, 17, 24 1993) (S. Hrg. 103-137).; The Home Equity Protection Act of 1993, Hearings on H.R. 3153 Before the Subcommittee on Consumer Credit and Insurance of the House Committee on Banking, Finance and Urban Affairs, 103d Cong., 2d Sess. (Mar. 22, 1994).

[40]15 U.S.C. 1641(d)(2).

[41]This places a burden on the prospective purchaser to review all the documentation, instead of just the note alone. Any documents which would itemize all dispersements, include fees and costs, must be reviewed. 15 U.S.C. § 1641(d).

without viable means to defend themselves from foreclosures and collection actions, even when claims and defenses are available. Also, if originators know that they effectively wash the loans of dirty – and illegal – deeds by selling them to the secondary market, there are no incentives built into the system to encourage compliance.

Congress recognized in 1994 just what the next Congress dealing with predatory mortgages must recognize – that the secondary market is the best policeman of the rules. The secondary market has access to the necessary information about each loan and each originator – because this information can be required to be provided with the purchase of each loan. The secondary market has the wherewithal to shut down access to money for bad actors, but will only have the incentive to do so if the failure to do so will cost the investors.

Most importantly consider the question of who should bear the risk in a faulty transaction. Assume 1) an *innocent consumer* (victim of an illegal loan), 2) an *originator guilty* of violating the law and profiting from the making of an illegal loan, and 3) an *innocent holder* of the illegal note. As between the two innocent parties – the consumer and the holder – who is best able to protect against the risk of loss associated with the making of an illegal loan? It is clear that the innocent party who is best able to protect itself from loss resulting from the illegality of another is not the consumer, but the corporate assignee.

An appropriate analogy is to the liability for stolen property. Again assume two innocent parties – the victim of the theft and the buyer of the stolen property. The law is clear that as between these two, the victim always gets the stolen property back.[42] The only way in which this analogy is different from the situation of the secondary market and predatory loans is that the secondary market is run by respected – and wealthy – members of the business community.

It is important to emphasize here that the secondary market has been found to be directly involved and at fault in predatory lending. In the recent FAMCO case, Lehman Brothers was found to have directly furthered the fraud of the originators in their predatory mortgage lending.[43]

Balancing the Real Need for Access to Funds in the Secondary Market. The secondary market does fill the important job of providing access to more capital for the subprime mortgage market. So a reasonable, balanced approach of holding the secondary market liable for the violations of the loan originators is necessary to ensure that some funds are still forthcoming. Just as it would not make sense for there to be *no* assignee liability, full assignee liability for an indeterminate amount of claims and damages may well shut down this funding source. While we believe some reduction in funding to the subprime market is appropriate, and we expect that one of the chief goals of legislation truly designed to stop predatory lending will intend to reduce

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[42]*See e.g.* Patty Gerstenblith, 11 Cardoza J.Int'l and Comp. L.409, *Acquisition and Deacquisition of Museum Collections and the Fiduciary Obligations of Museums to the Public,* Summer 2003.

[43]For a factual discussion of this case, *see In Re First Alliance Mortgage Company,* 298 B.R. 652 (C.D.Cal. 2003).

inappropriate and overly expensive mortgage loans, we agree that there need not be unlimited liability to assignees.

In the recent battles over assignee liability in the states, the various rating agencies have indicated on several occasions that they are able to fund lending in areas where there is assignee liability, but they need clear rules and clear limits on liability. **There should be no misunderstanding – the rating agencies have NOT refused to rate any loans with assignee liability.** Instead the rating agencies have specified that the damages must be determinable. If these damages are capped – and thus can be determined to be no more than a specific amount, then the loans, *even with assignee liability,* will be securitized and rated:

> Standard & Poor's defines assignee liability as liability that attaches to a purchaser simply by virtue of holding a predatory loan. If Standard & Poor's determines that there is no assignee liability, Standard & Poor's will generally permit loans covered by the statute to be included in rated transactions. If, on the other hand, a given state's anti-predatory lending statute does permit assignee liability, Standard & Poor's will evaluate the penalties under the statute. If damages imposed on purchasers are not limited to a determinable dollar amount, that is, the damages are not capped, Standard & Poor's will not be able to size the potential liability into its credit analysis. Therefore, these loans cannot be included in rated transactions. *If, on the other hand, monetary damages are capped, Standard & Poor's will be able to size in its credit analysis the potential monetary impact of violating the statute. (Emphasis added.)*[44]

Fitch has similarly stated that the current HOEPA standard for assignee liability was an acceptable method of measuring potential risk. Recently, when referring to Oklahoma's new law on predatory lending, Fitch said –

> Fitch has previously indicated that it will not rate REBS transactions that contain loans which are originated in jurisdictions that have enacted legislation that may result in unlimited purchaser or assignee liability for predatory lending practices of an originator, broker or service.
>
> . . .
>
> The potential damages described in the Act closely track potential damages described in 15 U.S.C.A. §§ 1640 and 1641, of the Truth in Lending Act (TILA). In fact, the language in the Act describing potential assignee liability is virtually identical to the relevant

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[44] Natalie Abrams, *Anti-Predatory Lending Laws Assume a Prominent Role in the U.S. REBS Market,* Ratings direct, www.ratingsdirect.com, Oct.7, 2003.

> sections of the federal Home Ownership and Equity Protection Act of 1994 (HOEPA), which amended the TILA. *Since the Act provides for assignee liability which, although greater than the loan balance, is limited, Fitch will rate REBS transactions containing all mortgage loans, . . . (Emphasis added).*[45]

Conclusion

Predatory lending is a serious problem in this nation, which is harming millions of homeowners, damaging communities, and undermining the national goals of advancing homeownership. Legislation that is seriously intended to address the problem must recognize the contributing factor to the problem of the availability of too much, inappropriate mortgage credit. However, unlimited assignee liability will shut down all funds which is a result which is not helpful. The answer lies in clear rules to stop predatory lending, with assignee liability capped at reasonable amounts. The goal must be to change the rules for mortgage lending in this nation so that no business can profit in the future from bad loans that plague America's homeowners.

In sum, we propose that legislation to address predatory lending include the following:

- Strict limits (ideally zero) on all points and fees which can be charged by lenders. Only discount points and prepayment penalties which are *bona fide* – actually in exchange for a truly negotiated reduced interest rate – should be permitted.
- Full assignee liability that is capped (per the current HOEPA rule) at the amount of the loan.
- The income tax rules should be amended to limit home secured debt to debt which is not only secured by the home, but is also obtained for reasons relating to the home. In exchange, individual taxpayers should be permitted some additional measure of deductions for personal credit *not* secured by the home.[46]

We also have suggestions for additional protections to deter foreclosures and add to valuable housing counseling resources, as well changes to the rules for Home Mortgage Disclosure Act to assist in enforcement of new and existing laws.

We remain happy to work on these and all other viable proposals to address the pernicious problem of predatory lending.

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[45] *Fitch Ratings Addresses Predatory Lending Legislation of Oklahoma*, October 30, 2003.

[46] We propose that changes to the tax code be essentially revenue neutral, to both the U.S. Treasury, and to most individual taxpayers, along the following basic guidelines: 1) Loans for home secured debt should be tax deductible only for that portion of the loan which is related to the purchase, repair or improvement of the home or related property, and 2) all individual taxpayers should be provided with a percentage of their income which can be deducted for expenditures spent for interest on consumer debt.

MISSION RESPONSIBILITY THROUGH INVESTMENT
NATIONAL MINISTRIES DIVISION

PRESBYTERIAN CHURCH (USA)

November 5, 2003

Testimony
By
Rev. William Somplatsky-Jarman
Committee on Mission Responsibility Through Investment
Presbyterian Church (USA)
Joint Hearings on "Protecting Homeowners: Preventing Abusive Lending While Preserving Access to Capital"
Subcommittees on Financial Institutions and Consumer Credit and Housing and Community Opportunity
United States House of Representatives Committee on Financial Services

The Presbyterian Church (USA), a major Protestant denomination with nearly 2.5 million members, is committed to consistency between its mission goals and ethical values and its investments. Through our Urban and Rural Church Networks, we are well aware of the need for access to capital to revitalize and maintain strong communities. We also are aware of roadblocks to such access, be they redlining or predatory lending practices. As investors in the major banking and financial institutions in this country, we have become increasingly concerned with predatory lending problems in the subprime loan market. Upon the acquisition of Associates First Capital in 2000 by CitiFinancial, a subsidiary of Citigroup, the Presbyterian Church (USA) and other church investors initiated a series of negotiations on their lending practices. These discussions along with Citigroup's settlement with the Federal Trade Commission regarding Associates practices, other regulatory investigations and pressures from community groups resulted in Citigroup having some of the best policies and practices in the subprime industry.

We, along with other church investors affiliated with the Interfaith Center on Corporate Responsibility, have been involved in dialogues with a number of subprime lenders, all of which have been subsidiaries of depository holding companies, including Washington Mutual's Long Beach Mortgage and Chase Manhattan Mortgage. We have just had our first meeting with Wells Fargo and expect to have dialogues with National City's First Franklin and KeyCorp's Champion Mortgage. One non-depository lender, Household, met once with the Sisters of Charity of the Incarnate Word and the General Board of Pensions and Health Benefits of the United Methodist Church, but the dialogue is on hold due to Household's acquisition by HSBC.

So far we have found that subprime lenders, which are subsidiaries of depository holding companies, largely have taken to heart the settlements of 2002 between the Federal Trade Commission and CitiFinancial and the 20 states attorneys general and Household, if they had not already had good practices in place.

Thus our concern is now turning to the smaller lenders, which are often finance companies and may be privately held or not widely held public firms. This new focus in part resulted from a

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chance reading of the *Denver Post* during our 2003 General Assembly last May. A story, entitled "Eccentric man loses his home but not his friends," described a 60-year old, disabled man who was evicted from the only home he had ever lived in because he could not pay a $387,000 mortgage received in 2001. The article observed that the man was a "notorious eccentric and pack rat who lived in squalor" and had no financial resources beyond Social Security disability checks worth less than $1,000 monthly. His home, in a trendy Denver neighborhood, was worth far more than the mortgage. A local mortgage company had made the loan at 4 points above the rate for people with good credit. Monthly payments were $3,254.11. No verification of financial status was done. The loan was sold to a bank specializing in subprime lending which foreclosed and then proceeded to buy the property at its own auction. The man's friends intervened to salvage a situation by buying the property from the bank, reselling it and establishing a trust to care for their friend. Whether this occurred, I do not know. Unfortunately, the story omitted why the mortgage company made the loan, and why the bank did not perform due diligence to insure that no predatory practices had been followed.

We find that these smaller lenders are usually not subject to any federal supervision other than through complaints filed with the Federal Trade Commission, and they probably represent some of the more egregious firms, such as First Alliance.

Thus the regulation of these smaller firms seems best achieved through secondary market mechanisms. The secondary market is the more logical route because these small firms usually do not have depository affiliates to supply their funding, and therefore they must sell their originated loans on a timely basis into the secondary market to preserve their liquidity.

There are actually two problems arising in the secondary market that we wish to address in our discussions: issuers and underwriters.

First is their need to perform adequate due diligence to eliminate their liability for handling loans from fraudulent loan originators such as First Alliance, where Lehman Brothers now has a court ordered liability of $5 million.

The second, perhaps more insidious case, is that of subservicing firms. These firms buy the servicing rights, often of the more risky loans. In buying these rights, they take on the job of dealing with loan delinquencies and foreclosures. In the case of Fairbanks Capital, the Federal Trade Commission has alleged that they counted on-time payments as late and assessed late fees, started unnecessary foreclosure proceedings to gain additional fees, etc.

Based upon the analysis of Dr. John Lind of CANICCOR, we are planning dialogues, especially with firms that serve as both issuers and underwriters, because these firms tend to handle loans from smaller lenders. These smaller lenders often use brokers as their primary source of loan applications. Since brokers are not employees of the lender, the lower level of control over the brokers can permit predatory practices by some of the brokers to go undetected. In addition, these issuer/underwriters use subservicers that have no relation to the lenders, and they may then use unethical practices in handling delinquencies and foreclosures. We believe that good policies and practices will promote more profitable companies in the long run.

Congress of the United States
Washington, DC 20515

October 7, 2003

The Honorable John D. Hawke, Jr.
Comptroller of the Currency
Office of the Comptroller of the Currency
250 E Street, SW
Washington, D.C. 20219

Dear Comptroller Hawke:

We are writing to express our strong concerns over efforts to promulgate regulations that exceed its statutory authority and are inconsistent with Congressional intent. Specifically, our concerns relate to the proposed regulations of April 23, 2003 pertaining to operations of federal branches and agencies of foreign banks.

Our fundamental structural problem with the proposed regulations is that they rely primarily on the National Bank Act (NBA) and the principle of national treatment, rather than specific authority granted by Congress in the International Banking Act (IBA). Such reliance essentially ignores the deliberate statutory scheme under which the NBA and the IBA were enacted by Congress. Had Congress intended to include provisions of the NBA in the IBA, it could have done so and would have done so directly. However, in this case Congress chose not to do so and thus reliance on the NBA and the principle of national treatment is unwarranted and inconsistent with Congressional intent.

Two provisions of the proposed regulations are particularly troublesome because they attempt to implement legislation pending in Congress before it is enacted. A third provision purports to license non-branch offices of foreign banks not authorized by the IBA. We address each in turn.

First, the regulations propose a definition of where a federal branch or agency is "located" that reverses the historical interpretation of the term in the 25 years since the IBA was enacted, is contrary to the plain language of the statute, and is inconsistent with Congressional intent. Defining "located" as "licensed" would lead to the absurd result that a foreign bank with multiple branches or agencies in multiple states would be deemed to be located only in the state in which it is licensed, rather than in each of the states where it maintains an office. This provision of the proposed regulations relates to the Capital Equivalency Deposit (CED) requirements under the IBA, which are the subject of pending legislation. At the OCC's request the pending legislation provides discretion to set the CED requirement. However, as you know, the Committee has limited that discretion so that the CED cannot be less than a "state floor" of the asset pledge in the state in which a federal branch or agency is located. Before the proposed regulations were published, there was no question about the definition of "located" or that the state floor applies to each state where an office is maintained. The proposed regulations, however, would administratively overturn the Committee's language, which is the same as language in current law, by effectively allowing a foreign bank with branches and agencies in multiple states to be "located" in only one state. Given the OCC's familiarity with the "state floor" provision in the pending legislation, we are particularly troubled by both the substance and the timing of the OCC's interpretation. You may be assured that Congressional intent – both in current law and in the pending legislation – is clear that a federal branch or agency is located in each state in which it maintains an office. As such, we fully expect that any final regulations will reflect this plain language of the statute and clear Congressional intent until such time as Congress changes the law.

Second, the attempt to authorize *de novo* interstate branching conflicts directly with current law. The proposed regulations ignore the fact that interstate branching operations of foreign banks are limited by state laws to the same extent as are national banks. Furthermore, as with the previous issue, pending legislation addresses interstate branching, and thus the proposed regulations are, at best, premature at this point.

Finally, the IBA provides that only specific, enumerated forms of organizations - federal branches and agencies - are authorized for foreign banks seeking federal licenses. Non-branch offices such as loan production offices, regional administrative offices and other administrative offices are not included in the IBA. Had Congress decided to authorize organizations other than federal branches and agencies, it could have done so. Since Congress did not authorize such offices by statute, it follows that the OCC cannot authorize them by regulation.

We urge you to withdraw these provisions of the proposed regulations until such time as Congress acts to amend the law and provide the requisite statutory authority that does not exist currently. We look forward to your prompt action on this important matter.

Sincerely,

PETER T. KING
Member of Congress

SUE W. KELLY
Member of Congress

CAROLYN B. MALONEY
Member of Congress

CAROLYN McCARTHY
Member of Congress

Quercia, R.G., Stegman, M.A., and Davis, W.R. 2003. "The Impact of North Carolina's Anti-Predatory Lending Law: A Descriptive Assessment." Center for Community Capitalism, University of North Carolina at Chapel Hill.

THE IMPACT OF NORTH CAROLINA'S ANTI-PREDATORY LENDING LAW: A DESCRIPTIVE ASSESSMENT

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Abstract

In this study, we examine changes in subprime lending activity before and after the North Carolina Anti-Predatory Lending Law was implemented in 1999 and 2000. Previous studies have noted a decline in overall subprime lending following the law's enactment. We suggest that such a finding is to be expected given that the purpose of the law was to reduce the number of subprime loan originations with predatory or abusive terms. To us, the relevant question is what component(s) of subprime lending declined, and which remained stable or increased after the law was implemented.

Using an analysis database of 3.3 million subprime loans covering 1998-2002, supplied to us under license by the company, Loan Performance, Inc., we find that the reduction in subprime originations observed from 1999 to 2000 is due to a decline in the number of refinance originations, while purchase originations actually increased. Most importantly, we find a large decline in subprime refinance originations with abusive or predatory terms. This is not unexpected since the law's intent was to curtail this type of lending. Overall, we conclude that after the North Carolina predatory lending law was fully implemented, the subprime market behaved essentially as the law intended: There was a reduction in predatory loans but no change in the cost of subprime credit or reduction in access to credit for high-risk borrowers.

Introduction

The 1990s were characterized by the aggressive expansion of credit to populations traditionally considered underserved, including those with limited or impaired credit histories, such as many minorities and recent immigrants. Financial institutions became more active in this so-called subprime area as a result of technological changes, a robust economy, and the need for new markets. Subprime borrowers have benefited from this expansion of credit, and institutions have seen profits increase through growth (Harvey and Nigro 2002).

In fact, subprime mortgage lending grew significantly over a very short period of time. Across the country, the volume of subprime mortgage originations grew from $35 billion to about $213 billion in only 8 years (1994-2002) (Mortgage Market Statistical Annual 2003). This increase reflects the growing involvement of secondary market institutions such as Fannie Mae and Freddie Mac in securitizing subprime mortgages. Securitized subprime loans increased from $11 billion to $83 billion from 1994 to 1999 (Harvey and Nigro 2002).

Subprime lending serves a wide range of borrowers, from those with minor credit imperfections to those with serious credit problems. In theory, the cost of borrowing increases as the quality of a borrower's credit declines, with the highest fees and rates charged to borrowers with the lowest credit quality. Problems may arise if unscrupulous lenders take advantage of uninformed borrowers by charging fees and rates not reflective of the risk, by not informing borrowers of their least expensive loan alternatives, and by offering products and services without full disclosure of terms and options.

The term "predatory lending" refers to a set of abusive lending practices concentrated in the subprime sector. These include making unaffordable loans based on the assets of the borrower rather than on the borrower's ability to repay an obligation; inducing a borrower to refinance a loan, often repeatedly, in order to charge high points and fees on the refinance ("loan flipping"); and engaging in fraud and deception to conceal from an unsuspecting or unsophisticated borrower the true nature of the loan obligation (Gramlich 2000). For service providers, regulators, and legislators, dealing with predatory lending requires a balancing act, because curbing these practices may curtail credit to some borrowers. Some borrowers may be so uncreditworthy that they can only get credit under conditions that are considered predatory. Historically, however, government has acted to curb abusive lending practices even if the regulations limit the flow of certain kinds of credit.

Predatory lending can have a devastating effect on families. Loans made without regard to a borrower's repayment ability are likely to erode the borrower's home equity position. This is especially true for minority and low-income families, for whom home equity comprises over 60 percent of their net worth (State of the Nation's Housing 2002). In addition, most older homeowners depend on equity to supplement other savings after retirement (Quercia 1997). The importance of home equity for these financially unsophisticated or vulnerable populations makes them potential targets of predatory practices (Carr and Kolluri 2001).

In the absence of direct evidence, and because predatory lending is largely a subset of subprime lending, the potential for abuse can be deduced by observing overall subprime lending patterns and changes over time. For instance, subprime loans are three times more likely in low-income neighborhoods than in high-income neighborhoods and five times more likely in black neighborhoods than in white ones. Furthermore, homeowners in high-income black areas are twice as likely as homeowners in low-income white areas to have subprime loans. Similarly, subprime loans are three times more likely among older borrowers than among younger borrowers (AARP 2003). These figures suggest that the negative impacts of abusive or predatory subprime practices may fall most heavily on those who have less access to prime credit (HUD 2000).

Unfortunately, there is no single, agreed-upon definition of what constitutes predatory lending. Those that exist are largely based on the definition of high-cost loans in the federal Home Ownership and Equity Protection Act (HOEPA) of 1994, which bans certain practices and requires additional disclosures and borrower protections. In 2000, about one percent of all subprime mortgage loans was estimated to fall under HOEPA (Gramlich

2000).[1] By contrast, estimates of predatory lending and actual settlements entered into by large subprime lenders suggest the true incidence may be considerably higher (for example, see Richardson 2003). Since 1994, several states and local jurisdictions have enacted HOEPA-like regulations and ordinances, so that high-cost or predatory loans have come to be defined as loans featuring one or more specified terms and underwriting practices, including exorbitant points and fees, balloon payments, prepayment penalties, loan flipping, as well as not requiring adequate documentation of repayment ability, and including interest rates on real estate-secured loans in and above the credit card range.

Critics have questioned whether legislative efforts to curb predatory practices would also increase the cost of serving particular segments of the market, reduce the supply of mortgage credit and raise the cost of borrowing (Elliehausen and Staten 2002 and 2003). Because North Carolina was the first state to enact anti-predatory legislation, its 1999 Anti-Predatory Law has received a great deal of attention. Examinations of the law's impact to date have had varied results.

This study is the first in a series to be prepared by the Center for Community Capitalism, a research center based in the Kenan Institute of Private Enterprise in the University of North Carolina at Chapel Hill, on the

[1] In 2002, revisions to Regulation Z (Truth in Lending act) expanded the definition of high-cost loans under HOEPA.

impacts of the North Carolina law and other issues related to subprime lending; all of which are to be supported by a database of subprime loans licensed to us by the company, Loan Performance, Inc.

This initial paper is entirely descriptive. We begin by enumerating the characteristics of the North Carolina Anti-Predatory Law and reviewing the literature to assess what is known of its impacts. Next, we describe the methodology and data used in this study; we introduce the Loan Performance database and compare subprime lending activities in the U.S., in selected Southern states, including North Carolina, and in the rest of the South. We examine changes in the number of subprime loans, both purchase and refinance, before and after implementation of the North Carolina law. We also examine changes in two measures that capture basic concerns about such laws: access to credit and the cost of credit for subprime borrowers. Next, we examine changes in subprime refinance originations with characteristics considered abusive or predatory.

Prior work on the impacts of the North Carolina law has focused on the overall subprime market. In contrast, the focus of our work is more properly on the impact of the law on specific market segments and on the supply of subprime credit with abusive or predatory features. In the final section, we discuss the directions for our future research.

The North Carolina Anti-Predatory Law: What Do We Know?

Enacted in 1999, North Carolina's Anti-Predatory Lending Law prohibits certain types of lending activities that are considered to be detrimental to consumers.[2] See Exhibit 1 for key characteristics of the law.

The law was enacted in two phases. In the fourth quarter of 1999, three elements of the law took effect. First, prepayment penalties were banned for loans up to $150,000. Second, permissible classes of fees were defined for loans secured by real property and for fees to be paid to third parties in association with the loan. Finally, consumer home loan refinancing transactions were prohibited where they failed to provide a borrower with a *reasonable, tangible net benefit* (the "no flipping" provision). The remaining requirements of the law took effect on July 1, 2000.

We have identified five studies that have examined the impacts of the NC law to varying degrees. The first, conducted by the trade publication, Inside B&C Lending (2001), reviewed rate sheets of several top subprime lenders to assess the range of products and prices offered in NC after enactment of the law. This study finds that subprime lenders in North Carolina were continuing to offer a full array of products and that there was little or no variation in rates charged. Moreover, while some companies opted to leave the

[2] (S.B.1149, codified at NCGS 24-1.1E, 24-10.2; effective 7/1/00) (S.B.1149, codified at NCGS 24-1.1E, 24-10.2; effective 7/1/00).

market, the study concludes it was not clear what role, if any, the predatory lending law played in those decisions.

Elliehausen and Staten (2002 and 2003) used loan-level data from nine members of the American Financial Services Association (AFSA) to compare subprime lending originations in North Carolina to those in Virginia, South Carolina, and Tennessee. The authors find that the North Carolina law resulted in a decline in overall subprime originations and in originations to low-income borrowers (<=$50,000 income) in North Carolina relative to the other two states.

Ernst, Farris, and Stein (2002) examined the volume of subprime originations before and after enactment of the law using Home Mortgage Disclosure Act (HMDA) data to compare 1999 and 2000 subprime originations for North Carolina with the rest of the nation. They find that there was an overall decline in the subprime market in North Carolina between those two dates, but that North Carolina was still among the most active subprime origination markets in the nation. They also found that despite the overall decline in subprime lending in North Carolina, the percentage of all subprime originations to lower-income borrowers remained unchanged. On the basis of this finding, the authors conclude that the overall decline was not just in the lower-income portion of the market but was distributed across the income spectrum. They also calculate that the law saved an estimated $100 million for North Carolina borrowers over the study period.

Morgan Stanley (2002) surveyed 280 subprime branch managers to assess the impact of predatory lending laws on lending activity across the country, and found that subprime residential lending volumes were not reduced in any significant way. The report specifically finds that "Even the toughest new laws, in states like North Carolina for example, do not seem to be affecting branch volumes" (Morgan Stanley: 2).

Finally, Harvey and Nigro (2002) examined loan application and denial rates in North Carolina and neighboring states using 1998-2000 HMDA data. They find that the law reduced the overall level of subprime mortgage lending activity in North Carolina relative to Virginia, Tennessee, South Carolina, and Georgia. However, they also report that the North Carolina decline was caused by a change in subprime loan application rates, not a change in denial rates. This suggests that the decline is a result of less demand rather than reduced supply.

Methodology and Data

As described above, all of the prior studies on the North Carolina Anti-Predatory Law focus on the impacts of the law on the overall subprime market. In contrast, we think the focus should properly be on the impacts of the law on market segments and market practices targeted by the law; in other words, on the law's impacts on the incidence of loans with predatory or potentially predatory characteristics. Thus, if the law has its intended effects, we would expect to find a decrease in subprime refinance originations, since most predatory loans are refinances, but not in purchase originations. We would also expect to find a decrease in refinance loans with abusive or predatory features, such as long-term prepayment penalties, balloon payments, and loans with combined loan-to-value ratios (LTV) for second lien refinances over 110 percent. We use the latter as a proxy for loans that do not reasonably offer tangible net benefits to borrowers.[3]

Our analysis is based on loan-level information for 3.3 million securitized subprime loans originated from 1998 through 2002. As indicated earlier, the data were supplied under license by Loan Performance, Inc. (formerly Mortgage Information Corporation), a private company founded 20 years ago to provide mortgage market research for regional banks. Over the years, Loan Performance developed a system to track the performance of agency and non-agency loans and securities and in 1997 started tracking subprime loans. The data for the analysis come from the company's Asset Based Securities (ABS) loan-level database.

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[3] Repeated refinancing of first mortgages with financed loan fees secured by second liens is common to loan flipping practices, and are likely to result in high combined loan-to-value ratios in the range of 110 percent or more. That very high combined loan-to-value (LTV) ratios are indicative of abusive lending practices is suggested in, among others, a recent report from the Washington State Department of Banking, where the state regulator criticized one subprime lender for "steering borrowers into larger first mortgages" and "situations where the borrowers were required to take out a second mortgage primarily to pay points on the first mortgage…." (Washington 2002). The NC law aims to reduce this predatory practice through its prohibition on originating refinance loans that do not provide the borrower a net tangible benefit. High combined LTV ratios also serve as a deterrent to prepayment, locking a borrower into high interest rate loans by making it economically infeasible for a responsible lender to offer a refinance loan (Washington 2003).

The Loan Performance (LP) database represents a significant share of the overall subprime market, ranging from approximately 41.6 percent in 1998 to about 51 percent in 2002 (see Table 1) (Mortgage Market Statistical Annual 2003). There is an overlap between the LP database and HMDA, although we cannot define it with full certainty. Many ABS lenders and issuers that report data to Loan Performance also report data under HMDA, including eight issuers on HUD's list of subprime lenders (HUD 2001) and a major lender active in both the prime and subprime mortgage markets. Ten of the top 25 ABS home equity issuers for 2002 report to LP (Koren 2003).

Relative to Elliehausen and Staten's database of about 300,000 subprime originations from nine AFSA members in 1998 (2002 and 2003), our LP database for the same year is twice as big, containing approximately 640,000 loans, and 3.3 million subprime loans for the overall study period, that ranges from Q1 1998 through Q3 2002.

Changes in the Subprime Market from 1998 through 2002

In this section, we examine overall trends in the subprime market from 1998 through 2002. First, we examine national trends in subprime originations using LP data and compare them with data from other sources. Second, we examine these trends at the regional level and for North Carolina and selected neighboring states. Third, we examine purchase and refinance subprime activity nationally and then regionally and in the selected states. Next, in the same areas, we examine changes in overall subprime lending, and for purchase and refinance activity, before and after the North Carolina law was implemented. Finally, we examine two specific concerns that have been raised about the law: its impacts on subprime borrowers' access to credit, and the cost of credit (Elliehausen and Staten 2002, 2003).

In comparing lending activity before and after the North Carolina Anti-Predatory Lending Law was enacted, it should be noted that the law was implemented in two steps that covered a transition period of three-quarters, or nine months. The first phase of the law became effective for loans originated on or after October 1, 1999 (i.e., at the start of the fourth quarter), and the second phase became effective on July 1, 2000 (the start of the 3rd quarter). Because this transition period was a time of uncertainty and adjustment for market participants that had to familiarize themselves with the new law, we do not believe that any short run changes in lending activity that occurred during this time are indicative of any long-term impacts of the law. This is why Tables 5-12 contain origination data going back seven quarters before the NC law was enacted, and seven quarters after the law was fully implemented, ignoring changes in activity that occurred during the 9-month transition period.

Decline in Subprime Originations

Nationally, there was a sharp decline in the total number of subprime loans originated from 1999 to 2000 (see Table 1), from almost $160 billion in 1999 to about $138 billion in 2000, a decline of about $22 billion (14.3 percent). Since then, there has been a steady increase in originations, and they have surpassed the 1999 level ($213 billion in 2002). The LP database shows similar declines and increases over time. The main difference is an increase in national subprime lending in the LP database of about 43 percent in 2001, compared with an increase of 25 percent for the same year reported elsewhere. The main reason for this disparity is that the LP database covered a larger proportion of the total subprime market in 2001 than it did in 1999.[4]

Subprime loan originations in the Southern census region, seen in Table 2, follow the same national pattern depicted in Table 1.[5] When the data are disaggregated, North Carolina and each of its neighboring states follow the same pattern observed nationally, with declines in all areas. From 1999 to 2000 subprime originations in North Carolina declined by 24 percent, in South Carolina by 18 percent, and in Virginia, by 17 percent. Tennessee, Georgia, and the rest of the South also experienced declines in subprime originations on a smaller scale.[6]

Although North Carolina experienced a somewhat greater decline in subprime originations from 1999 to 2000, it has also experienced a greater growth in such originations in 2001 and 2002 than the neighboring states of

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[4] If we adjust for the increased market coverage from 1999 to 2000, the growth in the LP database is 25.5%. Similarly, for 1998 to 1999, after adjusting for the increase in market coverage, the LP growth rate is 13.8%.

[5] In addition to North Carolina, the Southern Census Region includes MD, DE, VA, SC, TN, GA, FL, AL, MS, LA, TX, OK, and AR.

[6] It should be noted that Georgia's anti-predatory law took effect on the last quarter of 2002. It is possible that there was a big increase in originations in months immediately before the law took effect—originations of loans that would fall under the protection of the new law on 10/1/2002—inflating the 3rd quarter numbers. Because we estimate the 2000 annualized figures in Tables 3 and 5 based on originations for the first three quarters of 2002, we may be overestimating the amount of actual 4th quarter originations in Georgia.

South Carolina and Tennessee. More broadly, the percentage increase in the number of loans originated in North Carolina after 2000 is comparable with that of the rest of the South.

Two general trends can be observed in the number and relative change in subprime purchase and refinance lending, both nationally and regionally (see Tables 3 and 4). First, the 1999-2000 decline in subprime originations was for refinance loans only, not for the market as a whole. Specifically, North Carolina's 2000 growth in the purchase segment is in line with the rest of the South and only slightly smaller than the national trend. Second, since 2000, refinances have grown nationally and in some comparison states but not in North Carolina or in some other Southern states. In contrast, originations of purchase loans show big jumps in North Carolina and some other states but not in others.

Nationally, subprime purchase lending grew consistently from 1998 to 2002, with annual growth rates ranging between 6.7 percent and 13.1 percent (Table 3). From 1999 to 2000, the nation saw subprime purchase loan originations increase by 7.2 percent, while subprime refinances actually declined by more than 17 percent. In contrast, subprime refinances increased nationally in 2001 and 2002.

We find in North Carolina overall patterns similar to those for the country as a whole, in the South, and in other selected Southern states (Table

4). With regard to these overall trends in subprime lending, there seems to be nothing unique about North Carolina. Like the national trend, the number of subprime purchase originations in North Carolina from 1999 to 2000 did not decline. In fact, the number of subprime purchase loans grew steadily from 1998 to 2002, with a growth of more than 35 percent in 2001.

As before, subprime refinance activity declined from 1999 to 2000 throughout the South: in North Carolina, by 26 percent; in Virginia by almost 25 percent; in Georgia by 16 percent; in Tennessee by 14 percent; in South Carolina by 12 percent; and by about 13 percent in the rest of the region.

Lending Activity Before and After Implementation of the Law

Our research shows that in all geographies, the declines over time in subprime lending were due to drops in refinance activity and not in purchase lending originations. We explore this in more detail by examining changes in subprime lending before and after the North Carolina Anti-Predatory Lending Law was fully implemented. We examine trends for both purchase and refinance loans. If no declines are observed in purchase activity after implementation, we can infer that the North Carolina law is not keeping people from becoming homeowners by constraining the flow of subprime credit.

With the exception of Virginia and Georgia, subprime originations declined between pre and post implementation in North Carolina as well as in other neighboring states, the rest of the South, and the U.S. as a whole (see

Table 5). In North Carolina, however, where subprime originations declined by almost 5,300 loans, the relative decline was much greater than in other areas—17 percent compared with 8.2 percent or lower.

Looking at subprime refinance loans only before and after implementation of the law (Table 6), we find a decline of 20 percent in North Carolina with declines of 9 percent in South Carolina, 7 percent in Tennessee, and about 3 percent overall in the United States. During the same period, Virginia experienced no change in refinance originations while Georgia had a 10 percent increase. The more detailed analysis presented below indicates that North Carolina's decline in subprime refinance lending is largely in loans with characteristics that could be considered abusive or predatory.

When we examine the number and relative change in subprime purchase first lien loans before and after implementation (Table 7), we find that originations increased by 43 percent in North Carolina, with comparable increases in Virginia (44 percent) and Tennessee (39 percent). Georgia, the rest of the South, and the U.S. as a whole, experienced slower growth in this sector.

We conclude from this that the law does not limit access to subprime credit for North Carolina homebuyers, an issue that is examined in more detail below.

Effect of Predatory Lending Law on Credit

In this section, we examine two criticisms about predatory lending laws such as the one in North Carolina: that they will likely restrict access to credit for high-risk borrowers and increase the cost of credit because of lenders' unwillingness to serve this market (Elliehausen and Staten 2002 and 2003).

Access to Credit for High-Risk Borrowers

Concerns have been raised about the potential of the North Carolina law to curtail access to credit for high-risk borrowers. Elliehausen and Staten (2002 and 2003), using low income as a proxy for high-risk borrowers, find a decrease in the number of subprime loans to borrowers in North Carolina with incomes at or below $50,000.

There is a growing consensus among researchers in the field that the best measure of credit risk or creditworthiness is a borrower's credit score rather than income (Roche 2000), with a score below 580 considered to be a strong indication of high risk for default.[7]

Significantly, the North Carolina data show that loans to borrowers with credit scores below 580 have actually increased by almost one-third since the law was fully implemented (Table 8). This growth is consistent with that in neighboring states (except Tennessee), suggesting that changes in North

[7] Borrowers with credit scores below 580 are generally considered B- and C- quality borrowers (Calomiris and Mason 1999, p. 27)

Carolina's regulatory environment have had no detrimental impact on the supply of subprime credit to these high-risk borrowers.[8]

At the same time, we also find a relative decrease in the number of originations to borrowers with credit scores at or above 660 (Table 9). Although we are unable to determine the actual reason for this decline due to limitations of the LP database, such a decline is consistent with the proposition that the NC law may have curtailed the extent of steering creditworthy borrowers--whose credit scores are high enough to qualify for lower cost, prime loans--to the subprime market.[9]

The Cost of Credit after Implementation of the NC Law

Concerns have also been raised that predatory lending laws will increase the cost of credit for subprime borrowers. Elliehausen and Staten (2002 and 2003) report that North Carolina's regulation has reduced the flow

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[8] A word of caution is warranted. Some proportion of the increase is due to two factors. First, there was an increase in the coverage of the LP data, from 41 percent to 50 percent of the total subprime market over the study period. Second, there was an improvement in data reporting in LP. The percentage of records with missing FICO scores was reduced by more than half between 1998 and 2001. It is possible that lower credit scores are over-represented among the missing data. However, there's no reason to think those two factors would have a greater impact on North Carolina than in other Southern states. Thus, the conclusion that the experience in North Carolina has been similar to that of other states is still warranted.

[9] For instance, in 2000, Fannie Mae clarified its policies to minimize the potential steering of creditworthy borrowers to subprime products, and one would expect that borrowers with credit scores of 660 or higher would be among those referred to here. "For loans delivered to Fannie Mae, the company expects that lenders will have determined the borrower's ability and willingness to repay the mortgage debt regardless of the underwriting method the lender uses. In addition, lenders should have practices and procedures to offer mortgage applicants the full range of products for which they qualify, and should specifically avoid the steering of borrowers to high-cost products that are designed for less creditworthy borrowers if the applicants can qualify for lower-cost products. Similarly, consumers who seek financing through a lender's higher-priced subprime lending channel should be offered (or directed toward) the lender's standard mortgage product line if they are able to qualify for one of the standard products" (Raines 2000).

of subprime capital into the state. We do not agree. If the decline in overall originations had been due to lower capital flows, interest rates would be expected to rise in North Carolina relative to other states without predatory lending laws. If, however, the decline in subprime capital flows were demand-induced (i.e., the result of fewer subprime loan applications) interest rates would not be expected to rise. We examine this issue by comparing changes in the mean origination interest rates before and after implementation of the law, and discern no unique pattern in North Carolina compared with other states and the nation as a whole (Table 10). In fact, interest rates in North Carolina increased by 33 basis points (.33 of 1 percent) over the study period, which is below the corresponding national figure of 40 basis points.

Declines in Subprime Refinance Originations with Predatory Terms

As the earlier analysis indicates, after the law was implemented, North Carolina experienced a sharper decrease in subprime lending than neighboring states, with most of this decline concentrated in the refinance market. This pattern may be consistent with the intent of the law, because the refinance sector of the subprime market is generally more associated with abusive and predatory practices than other sectors.

We explore changes in the number of subprime refinance originations for loans containing at least one characteristic considered abusive or associated with predatory lending: prepayment penalty terms of 3 years or greater (Table 11), balloon payments (Table 12), and loan-to-value ratios of 110 percent or greater (Table 13). As suggested earlier, the latter is a proxy for loans with no "net tangible benefit" to borrowers. We expect originations of refinance loans with these abusive characteristics to have declined relatively more in North Carolina after the implementation of the law.

From the pre- to the post-law period, the number of refinance loans with prepayment penalty terms of three years or greater increased everywhere except in North Carolina (Table 11). There the number of such loans declined by 72 percent, a reduction of over 2,800 loans. In comparison, the number of such loans increased elsewhere, from a low of 35 percent in Georgia and the United States as a whole to a high of 260 percent in South Carolina.[10]

Looking at the number of subprime refinance loans with balloon payments originated before and after implementation, we find a decline of 53 percent, or over 1,600 loans, in North Carolina, although the contrast with neighboring states is not as clear as in the prior finding (Table 12). There were significant decreases in the number of these loans in two other states (South Carolina and Tennessee) and smaller decreases nationally and in the rest of the South. Only Virginia had an increase.

[10] We should mention, though, that South Carolina still has a very low incidence of originations with long pre-payment penalties. For example, prior to the NC law, only 5 percent of South Carolina's subprime originations had a 3-year or greater prepayment penalty. After the law, 16.6 percent of South Carolina originations had such penalties-- this compares favorably to a national average of 45.8 percent (and to VA, TN, and GA all with over 60 percent).

The number of refinance loans originated with a combined LTV equal to or greater than 110 percent pre- and post-implementation decreased by 35 percent, or about 650 loans, in North Carolina (Table 13). Half of the other study areas experienced an increase, while the others had declines much smaller in magnitude than in North Carolina.[11]

Conclusions

In this study, we examined changes in subprime lending activity before and after the North Carolina Anti-Predatory Lending Law was implemented. Using a database of 3.3 million subprime loans, we find a reduction in subprime originations from 1999 to 2000 due to a decline in the number of refinance originations, not loans for purchase, with most of the decline associated with loans having abusive or predatory terms. Rather than criticizing North Carolina's anti-predatory lending law for curtailing this kind of credit, it should be celebrated. Such a decline is not unexpected, since the law was enacted to curtail this type of lending. Moreover, we find that access to credit for high-risk borrowers and the cost of subprime borrowing in North Carolina have followed patterns similar to those elsewhere. Overall, we conclude that, after the law was fully implemented, the subprime market in North Carolina behaved essentially as the law intended—there was a reduction

[11] The findings in Tables 11-13 need to be put in context. This is because of two factors. First, there was an increase in the coverage of the LP database, from 41 percent to 50 percent of the total subprime market, over the study period. Second, there was an improvement in data reporting in LP, such that there is more missing information on loan characteristics in earlier than in later years. However, there is no reason to think these two factors would have a greater impact on North Carolina than in the other states. Moreover, if abusive or predatory characteristics were under-reported in early years, then our pre-post law examination is likely to understate actual declines in the number of loans with these features.

of loans with predatory terms without a restriction in access to or increase in the cost of loans to borrowers with blemished credit.

The analysis indicates an overall reduction of about 5,300 subprime loans pre- and post-implementation. Although we cannot estimate at the moment the precise degree of overlap, the analysis also indicates that this decline is largely due to a decrease in the number of loans with abusive characteristics. These include about 2,800 fewer loans with prepayment penalty terms of three years or more, about 1,600 fewer loans with balloon payments, and about 650 fewer loans with combined loan-to-value ratios over 110 percent. From this perspective, the observed decline cannot be considered undesirable or unanticipated by policymakers.

In closing, the findings from our initial study are strongly suggestive that the North Carolina Predatory Anti-Lending Law is doing what it is supposed to do. However, these findings cannot be considered definitive. In our future research, within a multivariate framework, we will incorporate confounding variables in the analysis (e.g., economic influences) to isolate the impacts of the North Carolina law on subprime lending activities.

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Exhibit 1
Key Features of the North Carolina Anti-Predatory Law

- Prohibits prepayment penalties on first-lien mortgages of less than $150,000;
- In high-cost home loans, prohibits the financing of fees, balloon payments, negative amortization, and lending without regard to a homeowner's ability to repay, where high-cost was defined generally as loans with fees in excess of 5 percent, or annual percentage rates over federal law trigger level, which is currently more than 8 percent above comparable U.S. Treasury Securities;
- Prohibits lenders from refinancing an existing home loan when there is no reasonable, tangible net benefit to a borrower;
- Prohibits the financing of single premium credit insurance; and
- Requires that would-be borrowers of high-cost loans receive financial counseling before entering into the transaction.

Source: N.C. Session. Law 1999-332, Section 5.

Table 1
Subprime Loans in the National LP ABS Database
Number and Volume
U.S. 1998-2002

Year	Number Of Loans, LP Database	Percentage Change	Total Volume, LP Database ($billions)	Percentage Change	Total National Subprime Volume ($billions)	Percentage Change	LP Database as Percent of All Subprime
1998	649,726	--	$62.4	--	$150.0	--	41.6%
1999	718,873	10.6%	$66.2	6.1%	$160.0	6.7%	41.4%
2000	616,254	-14.3%	$61.4	-7.3%	$138.0	-13.8%	44.5%
2001	696,324	13.0%	$87.6	42.7%	$173.3	25.6%	50.6%
2002*	769,745	10.5%	$108.4	23.7%	$213.0	22.9%	50.9%

* Annualized estimate based on originations for the first three quarters of 2002
Source: Loan Performance database and the 2003 Mortgage Market Statistical Annual, vol. 2

Table 2
Subprime Loans in the LP ABS Database
Number and Volume
Selected Southern States and Remainder of the South, 1998-2002

State	Year	Number Of Loans	Percent Change	Total Volume ($millions)	Percent Change
North Carolina	1998	16,174	--	$1,162	--
	1999	19,647	21.5%	$1,459	25.6%
	2000	14,893	-24.2%	$1,183	-18.9%
	2001	15,664	5.2%	$1,564	32.2%
	2002*	16,413	4.8%	$1,796	14.8%
South Carolina	1998	8,767	--	$569	--
	1999	10,355	18.1%	$717	26.0%
	2000	9,229	-10.9%	$713	-0.6%
	2001	8,834	-4.3%	$890	24.8%
	2002*	8,908	0.8%	$965	8.5%
Virginia	1998	12,862	--	$1,098	--
	1999	15,277	18.8%	$1,252	14.0%
	2000	12,605	-17.5%	$1,105	-11.7%
	2001	16,602	31.7%	$1,855	67.9%
	2002*	18,688	12.6%	$2,427	30.8%
Tennessee	1998	12,349	--	$871	--
	1999	15,072	22.1%	$1,091	25.3%
	2000	13,226	-12.2%	$996	-8.7%
	2001	13,679	3.4%	$1,137	14.2%
	2002*	13,764	0.6%	$1,191	4.7%
Georgia	1998	20,624	--	$1,763	--
	1999	24,069	16.7%	$2,066	17.2%
	2000	20,998	-12.8%	$2,046	-1.0%
	2001	25,218	20.1%	$2,815	37.6%
	2002*	28,323	12.3%	$3,295	17.0%
Rest of South	1998	133,137	--	$9,785	--
	1999	151,529	13.8%	$11,258	15.1%
	2000	136,672	-9.8%	$10,830	-3.8%
	2001	144,284	5.6%	$13,698	26.5%
	2002*	157,380	9.1%	$16,560	20.9%

* Annualized estimate based on originations for the first three quarters of 2002
Source: Loan Performance database and authors' calculations

Table 3

Subprime Loans in the National LP ABS Database
Purchase and Refinance Loans
U.S., 1998-2002

Year	Purchase, 1st Lien	Percent Change	Refinance	Percent Change	Other/ Missing
1998	160,003	--	386,572	--	73,792
1999	179,204	12.0%	472,258	22.2%	44,423
2000	192,019	7.2%	389,909	-17.4%	20,441
2001	204,950	6.7%	435,697	11.7%	5,683
2002*	231,871	13.1%	458,804	5.3%	1,861
Total	968,047		2,143,240		146,200

* Annualized estimate based on originations for the first three quarters of 2002
Source: Loan Performance database and authors' calculations

Table 4
Subprime Loans in the LP ABS Database
Purchase and Refinance Loans
Selected Southern States and Remainder of the South, 1998-2202

State	Year	Purchase, 1st Lien	Percent Change	Refinance	Percent Change
North Carolina	1998	3,050	--	10,151	
	1999	3,490	14.4%	14,070	38.6%
	2000	3,694	5.8%	10,369	-26.3%
	2001	5,021	35.9%	9,982	-3.7%
	2002*	5,115	1.9%	10,280	3.0%
South Carolina	1998	1,426	--	5,840	
	1999	1,974	38.4%	7,213	23.5%
	2000	2,474	25.3%	6,355	-11.9%
	2001	2,541	2.7%	6,023	-5.2%
	2002*	2,653	4.4%	5,887	-2.3%
Virginia	1998	2,678	--	7,663	
	1999	3,087	15.3%	10,567	37.9%
	2000	3,275	6.1%	7,955	-24.7%
	2001	4,305	31.5%	9,879	24.2%
	2002*	5,276	22.6%	9,981	1.0%
Tennessee	1998	2,500	--	7,894	
	1999	2,954	18.2%	10,470	32.6%
	2000	3,626	22.7%	9,015	-13.9%
	2001	3,953	9.0%	8,699	-3.5%
	2002*	4,177	5.7%	8,026	-7.7%
Georgia	1998	6,253	--	11,602	
	1999	6,558	4.9%	15,455	33.2%
	2000	6,747	2.9%	13,025	-15.7%
	2001	7,231	7.2%	15,553	19.4%
	2002*	8,039	11.2%	16,483	6.0%
Rest of South	1998	39,781	--	73,381	
	1999	45,717	14.9%	91,885	25.2%
	2000	48,367	5.8%	80,353	-12.6%
	2001	49,759	2.9%	84,911	5.7%
	2002*	54,499	9.5%	85,916	1.2%

* Annualized estimate based on originations for the first three quarters of 2002
Source: Loan Performance database and authors' calculations

Table 5
Number and Relative Change in Subprime Loans 7 Quarters Before and After NC Law
Selected Southern States, Remainder of the South, and the U.S.

Period	NC	SC	VA	TN	GA	Rest of South	Entire US
Pre-Law (Q1 1998 – Q3 1999)	31,184	16,284	24,629	23,550	38,660	245,600	1,190,755
Post-Law (Q3 2000 – Q1 2002)	25,898	14,948	26,979	22,583	41,689	242,537	1,157,489
% Change [(pre-post)/pre]	-17.0%	-8.2%	9.5%	-4.1%	7.8%	-1.2%	-2.8%

Source: Loan Performance database and authors' calculations

Table 6
Number and Relative Change in Subprime Refinance Loans
7 Quarters Before and After NC Law
Selected Southern States, Remainder of the South, and the U.S.

Period	NC	SC	VA	TN	GA	Rest of South	Entire US
Pre-Law (Q1 1998 – Q3 1999)	20,710	10,989	15,732	15,595	23,092	140,754	740,378
Post-Law (Q3 2000 – Q1 2002)	16,499	10,026	15,736	14,506	25,492	140,001	716,683
% Change [(pre-post)/pre]	-20.3%	-8.8%	0.0%	-7.0%	10.4%	-0.5%	-3.2%

Source: Loan Performance database and authors' calculations

Table 7
Number and Relative Change in Subprime 1st Lien Purchase Loans
7 Quarters Before and After NC Law
Selected Southern States, Remainder of the South, and the U.S.

Period	NC	SC	VA	TN	GA	Rest of South	Entire US
Pre-Law (Q1 1998 – Q3 1999)	5,622	2,845	4,949	4,666	11,054	73,168	289,042
Post-Law (Q3 2000 – Q1 2002)	8,037	4,404	7,127	6,488	12,251	85,255	350,523
% Change [(pre-post)/pre]	43.0%	54.8%	44.0%	39.0%	10.8%	16.5%	21.3%

Source: Loan Performance database and authors' calculations

Table 8

Number and Relative Change in Subprime Loans to Borrowers with FICO below 580
7 Quarters Before and After NC Law
Selected Southern States, Remainder of the South, and U.S.

Period	NC	SC	VA	TN	GA	Rest of South	Entire US
Pre-Law (Q1 1998 – Q3 1999)	6,608	3,976	3,656	5,602	7,814	53,164	220,911
Post-Law (Q3 2000 – Q1 2002)	8,671	5,253	5,017	6,712	10,319	68,124	289,392
% Change [(pre-post)/pre]	31.2%	32.1%	37.2%	19.8%	32.1%	28.1%	31.0%

Source: Loan Performance database and authors' calculations

Table 9

Number and Relative Change in Subprime Loans to Borrowers with FICO 660 and Above
7 Quarters Before and After NC Law
Selected Southern States, Remainder of the South, and U.S.

Period	NC	SC	VA	TN	GA	Rest of South	Entire US
Pre-Law (Q1 1998 – Q3 1999)	4,771	2,176	6,093	3,239	7,129	35,993	369,881
Post-Law (Q3 2000 – Q1 2002)	3,432	2,099	5,920	2,973	6,431	36,471	356,139
% Change [(pre-post)/pre]	-28.1%	-3.5%	-2.8%	-8.2%	-9.8%	1.3%	-3.7%

Source: Loan Performance database and authors' calculations

Table 10
Changes in Mean Origination Interest Rates
7 Quarters Before and After NC Law
All Subprime Loans
Selected Southern States, Remainder of the South, and the U.S.

Period	NC	SC	VA	TN	GA	Rest of South	Entire US
Pre-Law (Q1 1998 – Q3 1999)	10.27	10.34	10.34	10.20	10.01	10.16	9.88
Post-Law (Q3 2000 – Q1 2002)	10.60	10.60	10.42	10.60	10.31	10.57	10.27
% Change Pre to Post	3.3%	2.5%	0.8%	3.9%	3.0%	4.0%	4.0%
Basis Points Change Pre to Post	33	26	9	40	30	41	40

Source: Loan Performance database and authors' calculations

Table 11

Percentage of Subprime Refinance Loans with Prepayment Penalty Terms of 3 years or Greater
7 Quarters Before and After NC Law
Selected Southern States, Remainder of the South, and the U.S.

Period	NC	SC	VA	TN	GA	Rest of South	Entire US
Pre-Law (Q1 1998 – Q3 1999)	3968	435	5170	7535	11653	53577	247573
Post-Law (Q3 2000 – Q1 2002)	1101	1569	8530	9318	14605	63895	296457
% Change [(pre-post)/pre]	-72.3%	260.7%	65.0%	23.7%	25.3%	19.3%	19.7%

Source: Loan Performance database and authors' calculations

Table 12
Number and Percent Change in Subprime Refinance Loans with Balloon Payments
7 Quarters Before and After NC Law
Selected Southern States, Remainder of the South, and the U.S.

Period	NC	SC	VA	TN	GA	Rest of South	Entire US
Pre-Law (Q1 1998 – Q3 1999)	3092	1273	1427	1720	2172	10276	68146
Post-Law (Q3 2000 – Q1 2002)	1451	430	1981	766	1544	7566	57480
% Change [(pre-post)/pre]	-53.1%	-66.2%	38.8%	-55.5%	-28.9%	-26.4%	-15.7%

Source: Loan Performance database and authors' calculations

Table 13

Number and Percent Change of Subprime Refinance Loans
With a Combined Loan-to-Value of 110 Percent or Greater
7 Quarters Before and After NC Law
Selected Southern States, Remainder of the South, and the U.S.

Period	NC	SC	VA	TN	GA	Rest of South	Entire US
Pre-Law (Q1 1998 – Q3 1999)	1,827	783	3,160	815	2,152	11,067	55,792
Post-Law (Q3 2000 – Q1 2002)	1,189	809	2,923	1,122	2,056	13,308	56,818
% Change Pre to Post	-34.9%	3.3%	-7.5%	37.7%	-4.5%	20.2%	1.8%

Source: Loan Performance database and authors' calculations

Statement of

America's Community Bankers

on

Protecting Homeowners: Preventing Abusive Lending While Preserving Access to Credit

before the

Subcommittee on Housing and Community Opportunity and Subcommittee on Financial Institutions and Consumer Credit

of the

Committee on Financial Services

of the

U.S. House of Representatives

on

November 5, 2003

America's Community Bankers

Washington, DC

America's Community Bankers appreciates this opportunity to submit a statement on the problem of predatory lending practices. ACB members include state and federally chartered savings institutions and commercial banks. Our members are both stock- and mutually owned. As community bankers, many are specialists in mortgage lending.

Position Statement on Predatory Lending

ACB is committed to ensuring that all Americans have fair and equitable access to credit, and that consumers have the necessary skills to make wise credit and other financial decisions. ACB also supports the development of a federal legislative response, such as the bipartisan Ney-Lucas proposal, "Responsible Lending Act"- H.R. 833, that would establish national uniform standards to combat predatory lending practices, while avoiding a patchwork of state and local legislative responses that could disrupt the critical national marketplace for real estate credit.

Responsible subprime lending is an important way to offer more Americans greater access to credit. Policy makers should not impose new laws and regulations that inaccurately label subprime loans as "predatory" or that stigmatize legitimate loan terms.

ACB believes that Congress should vigorously pursue national, uniform anti-predatory lending standards. This type of standard would create uniformity and ensure consistency among state-based mortgage lending initiatives. A uniform national standard would have significant additional benefits for consumers, including:

- Curbing abusive and deceptive practices by lenders who shop for venues that lack tough laws. Once exposed, these scam artists shut down, find another location and open under another name.

- Promoting efforts to educate consumers. The best defense against predatory lending is a well-informed consumer in a competitive marketplace.

- Preserving the efficiencies of a national market, which reduces costs for both consumers and businesses, improves consumer access to credit, permits lenders to reward good performance with lower rates and facilitates credit to higher risk borrowers.

ACB also urges that the following steps be taken to advance financial literacy and combat predatory lending practices:

- Interested affected parties should take steps to increase the levels of financial literacy among all Americans, including specifically working to increase and expand homeownership education and credit counseling;

- Consumer education programs should incorporate information regarding how to avoid identity theft, a key element of some abusive consumer credit practices, including regular and routine management of one's credit files;

- Among school-aged children, interested affected parties should work cooperatively to improve basic financial education at every level in the education process, including how to properly save money as well as avoid the various pitfalls of obtaining too much credit;

- Enforcement agencies should vigorously enforce existing laws and focus their attention on lenders who are not subject to examinations or supervision, rather than applying new restrictions on regulated lenders;

- The federal banking agencies should increase support of their supervised institutions' financial literacy efforts;

- The Department of Housing and Urban Development should continue its mortgage disclosure reform efforts, including mortgage broker disclosure, and work to develop meaningful changes that result in improved and simplified mortgage transaction disclosures for consumers.

- HUD, the Federal Reserve Board and others should explore ways to improve and simplify disclosures and field-test proposed revisions.

Explanation

Members of ACB are community-based lenders dedicated to strengthening America's communities by meeting the financial needs of customers fairly and efficiently and by fostering housing opportunities and equal credit opportunity. Communities are supported by providing housing finance, consumer credit and small business lending and other financial services that contribute to economic vitality and job creation. Predatory lending practices harm communities.

An informed, educated consumer is better able to make financial decisions and avoid predatory, unscrupulous providers of financial services. Education and counseling remain an important way to prevent predatory lending abuses.

In 2002, ACB launched *Money Rules*, a financial literacy program designed to provide community bankers with materials for their financial education efforts. Since inception, we have distributed one million brochures. In addition, ACB is working with a variety of federal agencies and private organizations, including the Federal Deposit Insurance Corporation, Junior Achievement, Operation HOPE, Inc., and the Jump$tart Coalition for Personal Financial Literacy, to help educate people about such topics as the importance of saving, establishing a good credit history and how to borrow wisely. These initiatives follow earlier efforts in the area of homeownership education and counseling. ACB was a founding member of the American Homeowner Education and Counseling Institute, and remains committed to improving the quality, effectiveness and impact of homeowner education and counseling.

Policy makers should thoroughly study why the existing disclosure regime is ineffective and what alternatives might work. Those efforts should concentrate on simpler, "plain English" disclosures that focus consumer attention on relevant information. In particular, ACB generally supports the reform efforts of the Department of Housing and Urban Development that might ensure that consumers are given accurate, timely and simplified disclosures on which to base their housing finance decisions.

Policy makers should distinguish between "subprime lending" programs and "predatory lending" practices. These terms are often mistakenly used interchangeably. Subprime lending provides financing to individuals with credit blemishes or other risk factors, though at somewhat higher rates or under stricter terms than are available to more credit worthy borrowers. The rise of subprime lending has given many previously underserved borrowers access to credit.

ACB also believes that vigorous enforcement of existing laws with respect to unsupervised lenders is critical. The joint report by the Federal Reserve Board and the Department of Housing and Urban Development issued in 1998 acknowledged this, stating: "Abusive mortgage loans are not generally a problem among financial institutions that are subject to regular examination by federal and state banking agencies. Abuses occur mainly with mortgage creditors and brokers that are not subject to direct supervision."

At the same time, ACB believes that, absent Congressional action to establish uniformity, ongoing initiatives across the country are leading to a patchwork of well-intentioned but overly burdensome state and local laws and regulations that are not benefiting consumers and are forcing banks out of the market.

Conclusion

ACB strongly supports the Committee's effort on this very important issue. We look forward to working with you and your staff as you craft legislation to accomplish this goal.

AMERICAN
LAND TITLE
ASSOCIATION

November 4, 2003

The Honorable Bob Ney
Housing and Community Opportunity Subcommittee
Committee on Financial Services
U.S. House of Representatives
Washington, DC 20510

The Honorable Spencer Bachus
Financial Institutions and Consumer Credit Subcommittee
Committee on Financial Services
U.S. House of Representatives
Washington, DC 20510

Dear Chairman Ney and Chairman Bachus:

The American Land Title Association[1] (ALTA) would like to submit this letter for the record in connection with the joint hearing being held by the Subcommittees on Housing and Financial Institutions on November 5, 2003 entitled "Protecting Homeowners: Preventing Abusive Lending While Preserving Access to Credit."

The purpose of this submission is to emphasize ALTA's view regarding the circumstances in which title, escrow and other similar title-related charges should (or should not) be included in the definition of "points and fees" to determine when a mortgage loan becomes a "high cost" loan subject to the additional disclosures and obligations provided by the Home Ownership and Equity Protection Act of 1994 ("HOEPA"). ALTA believes Congress should maintain the current "exclusion" of title charges, escrow and title-related, from the high cost loan test and should consider expanding the exclusion to title companies affiliated with creditors.

HOEPA amended section 129 of the Truth in Lending Act ("TILA"), which specifies certain additional disclosures and substantive obligations when lenders make so-called "high-cost" mortgage loans – or what is technically described in §129 as a "mortgage referred to in section 103(aa)." A high-cost loan is defined in §103(aa)(1) as a mortgage loan with a high annual percentage rate (APR) (i.e., more than 10 percentage points higher than the yield on Treasury securities having a comparable maturity) or a loan

[1] •The American Land Title Association membership is composed of 2,400 title insurance companies, their agents, independent abstracters and attorneys who search, examine, and insure land titles to protect owners and mortgage lenders against losses from defects in titles. Many of these companies also provide additional real estate information services, such as tax search, flood certification, tax filing, and credit reporting services. These firms and individuals employ nearly 100,000 individuals and operate in every county in the country.

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where "the total points and fees payable by the consumer at or before closing will exceed the greater of (i) 8 percent of the total loan amount; or (ii) $400 (adjusted for inflation)."

In determining what constitutes "points or fees" for purposes of this provision, §103(aa)(4)(C) provides that points and fees shall include "the charges listed in section 106(e)" – which, in turn, includes "[f]ees or premiums for title examination, title insurance, or similar purposes" – but such fees shall be excluded if:

the charge is reasonable;

the creditor receives no direct or indirect compensation; and

the charge is paid to a third party unaffiliated with the creditor.

In other words, reasonable charges by independent title entities who are not affiliated with the lender, and where the lender does not receive direct or indirect compensation in connection with the charge, are not counted toward the 8%/$400 "points and fees" threshhold that can turn a mortgage loan into a "high-cost" loan. We believe that this is an appropriate and long-standing approach to when such title charges should not be included in the definition of "points and fees."

In recent years, many title companies have become affiliated with mortgage lenders. If the charges made by such title companies are reasonable, ALTA does not believe that the mere fact that the company is affiliated with the lender should automatically cause any charges made by that title company to be included within the "points and fees" threshhold. Accordingly, in considering any legislation on predatory lending, the subcommittees may want to consider the deletion of the third requirement.

That is, if a title company's charges are reasonable and if the creditor receives no direct or indirect compensation because the title company was involved in the transaction (e.g., the creditor receives no referral fee for recommending the title company), the fact that the title company is affiliated with the creditor should not automatically bring the title company's charges within the definition of "points and fees."

We appreciate the Subcommittees' consideration of these comments and the inclusion of this letter in the record of this hearing. If you have any questions, please do not hesitate to contact me or Charlene Nieman, ALTA Grassroots and PAC Manager.

Sincerely,

Ann vom Eigen

Ann vom Eigen
Legislative and Regulatory Counsel

SEPARATE AND UNEQUAL

Predatory Lending in America

November 2002

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Association of Community Organizations for Reform Now
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202-547-2500
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Acorn Housing Corporation
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ACORN Fair Housing
A Project of the American Institute of Social Justice
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ACORN, the Association of Community Organizations for Reform Now, is the nation's largest community organization of low- and moderate-income families, with over 120,000 member families organized into 600 neighborhood chapters in 45 cities across the country. Since 1970 ACORN has taken action and won victories on issues of concern to our members. Our priorities include: better housing for first time homebuyers and tenants, living wages for low-wage workers, more investment in our communities from banks and governments, and better public schools. We achieve these goals by building community organizations that have the power to win changes -- through direct action, negotiation, legislation, and voter participation. ACORN's website is at http://www.acorn.org.

ACORN HOUSING CORPORATION

In 1986, ACORN Housing originated from neighborhood-based campaigns conducted by ACORN, a national organization formed by low-income members to improve neglected, impoverished communities. ACORN Housing creates affordable housing opportunities by acquiring and rehabilitating affordable housing units, developing single-family homes, providing homeownership counseling, coordinating sweat-equity programs, creating groundbreaking mortgage financing programs, and securing homebuyer subsidies. Since its inception, ACORN Housing's homeownership and counseling program has grown to 29 cities and provides free mortgage counseling to more individuals than any other organization in the country. ACORN Housing is also the national leader in assisting victims of predatory lending by providing refinancing at improved terms, through loan modification, and by providing outreach that teaches individuals to identify and avoid predatory loans.

ACORN Fair Housing Organization

ACORN Fair Housing fights housing discrimination by conducting research, providing training for community organizations, and conducing outreach and education efforts on the Federal Fair Housing Act. ACORN Fair Housing has worked against insurance and mortgage redlining and is currently working to identify victims of discrimination who have obtained predatory mortgage loans. ACORN Fair Housing is a project of the American Institute for Social Justice.

SEPARATE AND UNEQUAL
Predatory Lending in America

INTRODUCTION

Jonathan and Darlene and their two children had lived in their home since 1995, which had risen in value since then; Jonathan works as a carman for the railroad. They had bought the house with a 7% interest rate mortgage and later took out a 12% second mortgage. After another few years, they started receiving phone calls and solicitations in the mail from Beneficial, a part of Household Finance. In August 2001, Beneficial pressured them to consolidate debts into a third lien for $23,000 at a 21.9% interest rate. The mailings and phone calls kept coming, and three months later Beneficial convinced them to consolidate their three mortgages and pay off some other debts.

Beneficial never told Jonathan and Darlene that it had financed nearly $18,000 in 7.0 discount points into their loan, increasing the principal to over $248,000. The loan amount was also inflated by a single-premium credit life insurance policy for almost $8,000, despite Jonathan's telling the loan officer to not include it because he has a much less expensive term life insurance policy. And despite all the discount points, their history of never missing a home or car payment, and the fact that nearly two-thirds of the loan amount went toward the 7% first lien, fees, and credit insurance, the new loan contained an interest rate of 10.4%. Beneficial never told them that the new payments would not cover taxes and insurance, and the loan did not pay off all the debts Beneficial had promised. They were told the loan had a three-year prepayment penalty but not that the amount was over $6,000. The high monthly payments forced them to cut back on other expenses, and the high loan-to-value ratio plus the prepayment penalty prevented them from refinancing to a more reasonable rate. In the end, they had little choice but to sell their house and buy a less expensive one; they'll never get back the $26,000 of equity Beneficial stripped away, but their new mortgage with another lender will have an interest rate of 7.5%.

Mason and Josie are an elderly African-American couple who have excellent credit and whose primary source of income is Mason's veteran's benefits. Their mortgage was at a 7% interest rate when a broker convinced them to consolidate some credit cards into the mortgage. While the new mortgage for $99,000 had a reasonable interest rate of 8.4%, the broker also slipped in a second mortgage for $17,000 at an interest rate of 13.0%. The first loan for $99,000 also financed in nearly $6,000 in broker and third-party fees, and both loans contained prepayment penalties – lasting for three and five years, respectively. The broker used a series of payment schedules to confuse them, and they didn't realize that both loans had balloon payments after 15 years. After making monthly payments of nearly $950 over the next fifteen years, Mason and Josie will face a balloon payment for $93,000.[1]

[1] All of the examples of predatory lending abuses on subprime loans cited in this study were made in 2001 or 2002. The one exception is the balloon payment example, which was originated in 1996 with the balloon coming due in 2001 (the second story in the introduction also provides an example of a balloon payment loan originated in 2001).

The above families are just two of the millions of unsuspecting homeowners and homebuyers who have been robbed by predatory lenders – mortgage and finance companies that make loans with high interest rates, exorbitant fees, and harmful terms, often through fraudulent and deceptive methods. Elderly homeowners, communities of color, and low-income neighborhoods are the most severely impacted by these practices.

Despite increased awareness of the issue and some progress over the last year in combating the problem, predatory lending has continued, as these modern day loan sharks sink their teeth into new prey every day. In 2001, for the eighth consecutive year, home prices nationally rose at a greater rate than general inflation, exacerbating the problem by making more homeowners targets for predatory lenders intent on stripping their equity.[2]

Nationally, the number of subprime loans has skyrocketed since the early 1990s. In 1993, just over 100,000 subprime refinance and home purchase loans were originated, compared to over a million subprime loans in 2001. The proportion of subprime loans compared to all home loans fell somewhat from 2000 to 2001, but this was primarily a reflection of the growth in prime refinances due to historically-low interest rates. Even then, however, the growth in prime refinances for African-Americans (131%) and Latinos (231%) substantially trailed the increase for whites (294%). The subprime industry's tremendous growth has continued through the first half of 2002, as the volume of subprime originations rose to $106 billion, an increase of 19% compared to the first half of 2001 and the highest figure since the data started being collected a decade ago.[3]

The rise in subprime and predatory lending has been most dramatic in minority communities. Subprime lenders account for half, 51 percent, of all refinance loans made in predominantly black neighborhoods, compared to just 9 percent of the refinance loans made in predominantly white neighborhoods.[4] Subprime lending, with its higher prices and attendant abuses, is becoming the dominant form of lending in minority communities. But while minority communities suffer from an extreme concentration of higher cost, harmful loans, the problem should not be viewed as one that only affects minorities, since the vast majority of borrowers in subprime loans – and thus the vast majority of predatory lending victims – are white.

While not all subprime lenders are predatory, just about all predatory loans are subprime, and the subprime industry is a fertile breeding ground for predatory practices. Subprime loans are intended for people who are unable to obtain a conventional prime loan at the standard bank rate. The loans have higher interest rates to compensate for the potentially greater risk that these borrowers represent. There is a legitimate place for flexible loan products for people whose credit or other circumstances will not permit them to get loans on 'A' terms. Predatory lending occurs when loan terms or conditions become abusive or when borrowers who should qualify for credit on better terms are targeted instead for higher cost loans.

[2] *The State of the Nation's Housing: 2001*, Harvard University Joint Center for Housing Studies, p. 1.
[3] "Subprime Volumes Keep Rockin'", *National Mortgage News*, by Paul Muolo, September 16, 2002, p. 38.
[4] *Curbing Predatory Home Mortgage Lending: A Joint Report*, June 2000, U.S. Department of Housing and Development and U.S. Department of Treasury, p. 47.

Fannie Mae has estimated that as many as half of all borrowers in subprime loans could have instead qualified for a lower cost mortgage.[5] Freddie Mac suggested a somewhat lower, but still extremely large figure – that as many as 35 percent of borrowers who obtained mortgages in the subprime market could have qualified for a prime loan.[6] The difference this could make is enormous: borrowers can easily pay $200,000 more in payments on a subprime loan over its 30 year life.

Too often higher rate subprime loans are also loaded with abusive features – high fees, large and extended prepayment penalties, financed single premium credit insurance – which cost borrowers even more money, and can lock them into the higher rates. When a borrower with good credit in a high rate loan is also charged inflated up front fees, assessed a prepayment penalty, and/or sold financed single premium credit insurance, it often leaves them without enough equity to refinance into a loan at a more reasonable rate.

Those borrowers who are not in a position to qualify for an 'A' loan are also routinely overcharged in the subprime market, with rates and fees that reflect what a lender or broker thought they could get away with, rather than any careful assessment of the actual credit risk. These loans too are often loaded with additional abusive features like financed credit insurance, hidden balloon payments, and mandatory arbitration clauses. As a result, such borrowers also find themselves trapped in high rate loans even once they have improved their credit. Many borrowers are also repeatedly solicited, and repeatedly refinanced into high rate loans, losing equity through every transaction.

Unfortunately, these problems pervade too much of the subprime industry. Just in the past few months, two of the largest subprime mortgage lenders – Household International and The Associates, which is now owned by Citigroup – announced respective settlements of $485 million and $240 million for engaging in predatory lending practices. While these are the largest settlements in American history for any type of consumer complaints, the dollar figures are well below the financial damage these companies have inflicted on their borrowers. Abuses are also widespread among unscrupulous mortgage brokers, who convince consumers they are acting to secure the lowest-priced loan when they are actually taking kickbacks from lenders to jack up interest rates, in addition to their standard origination fees.[7]

Predatory lending practices are even more insidious because they specifically target members of our society who can least afford to be stripped of their equity or life savings, and have the fewest resources to fight back when they have been cheated. Subprime lending is disproportionately concentrated among minority, low-income, and elderly homeowners.[8] Over 1.8 million lowest-income senior citizen homeowners pay more than half their incomes for housing, leaving them with little room to make increased mortgage payments.[9]

Many in the lending industry argue that the disproportionate concentration of subprime loans among low-income and minority borrowers is only a reflection of the greater risk that these borrowers represent based on their lower credit ratings. However, Fannie Mae has stated that the racial and economic disparities in

[5] "Financial Services in Distressed Communities," Fannie Mae Foundation, August 2001.
[6] "Automated Underwriting," Freddie Mac, September 1996.
[7] See testimony of Harvard Law School Prof. Howell E. Jackson to the Senate Banking Committee hearing on "Predatory Mortgage Lending Practices: Abusive Uses of Yield Spread Premiums," January 8, 2002.
[8] "We think [predatory lending is] at epidemic proportions, particularly in low-income, elderly and minority communities." Craig Nickerson, vice president of community development lending, Freddie Mac, as quoted in "Campaign to Help Buyers Avoid Predatory Loans", *Los Angeles Times*, by Lee Romney, July 18, 2001, Business p. 1.
[9] *The State of the Nation's Housing: 2001*, Harvard University Joint Center for Housing Studies, pp. 26-27.

subprime lending cannot be justified by credit quality alone. According to Fannie, loans to lower-income customers perform at similar levels as loans to upper-income customers; indeed, some recent research suggests that mortgages to low- and moderate-income borrowers perform better than other mortgages when the lower prepayment risk is taken into account.[10] In addition, the level of disparity presented in studies which showed that black households had more credit problems than white households was not even close to the levels of disparities seen in subprime lending.[11]

Predatory lending threatens to reverse the progress that has been made in increasing homeownership rates among minority and lower income families. Many in the subprime industry like to portray their primary role as helping families realize the American dream of homeownership. But the vast majority of subprime loans are refinances and home equity loans to existing homeowners, not purchase loans; last year, more than 65% of the reported home loans made by subprime lenders were for refinances, and an additional 6% were home-improvement loans.

While it is important for homeowners to be able to use the equity in their homes to meet financial needs, predatory lenders bombard homeowners in many communities with refinance offers that lead to loans at high rates, with inflated fees, and other abusive terms. By stripping equity, increasing indebtedness, and even costing families their homes, these practices cause homeowners to lose their equity, rather than use it for their benefit.

Furthermore, when we do examine the subprime industry's role in the home purchase market, there is additional cause for concern. From 1993 to 1995 there was a substantial increase in prime home purchase loans to minorities. Since then, however, the number of prime loans has stagnated, while the number of subprime purchase loans has skyrocketed. From 1995 to 2001 the number of subprime purchase loans to African-American homebuyers rose 686%, while the number of prime conventional purchase loans to African-American homebuyers actually fell 5.7%. A huge homeownership gap remains, with over three-quarters of white households owning their own homes, compared to less than half of African-American and Latino families.

This, along with the data from Fannie Mae and Freddie Mac mentioned above, suggests that higher cost subprime loans are replacing rather than supplementing less expensive 'A' credit, with tremendous extra costs for borrowers who should be qualifying for, or previously were in, 'A' loans. When buyers who should be eligible for loans at good interest rates are instead steered towards subprime lenders, they end up paying hundreds of dollars more each month than they would with a prime loan, and the higher interest rates and added fees deprive these homeowners of a fair opportunity to build equity. In the worst cases, the high interest and fees are only the tip of a predatory lending iceberg in which the loan also contains harmful terms, and the combination of these factors greatly increase the likelihood of foreclosure. The prevalence of predatory lending abuses in the subprime market has been a major factor behind record-breaking foreclosure rates; the Mortgage Bankers Association's survey of borrowers entering foreclosure and mortgages already in foreclosure for second quarter 2002 showed the highest percentages in each category since the statistics first started being tabulated in 1972.[12]

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[10] "Performance of Low-Income and Minority Mortgages," by Robert Van Order and Peter Zorn, in *Low-Income Homeownership: Examining the Unexamined Goal*, ed. Nicolas Retsinas and Eric Belsky, 2002, p. 324.
[11] "Financial Services in Distressed Communities," Fannie Mae Foundation, August 2001.
[12] "2nd Quarter Foreclosure Rates Highest in 30 Years," *Washington Post*, by Sandra Fleishman, September 14, 2002, p. H1.

In addition, subprime purchase loans are the financing mechanism of choice for carrying out "property flipping" scams, which unfortunately have become all too common an occurrence in a number of cities. Property flipping involves the purchase of distressed properties at a negligible price, and then, after minimal cosmetic or even no repairs, the property is sold at prices far above their actual worth. The victims of property flipping are often unsuspecting low-income, minority first-time homebuyers.

The damage that predatory lending inflicts on our communities cannot be overestimated. Homeownership provides the major source of wealth for low-income and minority families, with around two-thirds of their wealth coming from home equity. Rather than strengthening neighborhoods by providing needed credit based on this accumulated wealth, predatory lenders have contributed to the further deterioration of neighborhoods by stripping homeowners of their equity and overcharging those who can least afford it, leading to foreclosures and vacant houses.[13]

The last few years have seen a growing recognition of the serious harm being caused by predatory lending, and federal and state regulators have begun to take modest yet significant steps against the abuses. The Office of Thrift Supervision moved forward in September with regulations that effectively restored consumer protection laws on late fees and prepayment penalties in about half the states. Last December, the Federal Reserve used its regulatory authority under the federal Home Ownership Equity Protection Act (HOEPA) to announce two significant changes that went into effect in October – counting single-premium credit insurance policies as a fee under the HOEPA test, and expanding HOEPA coverage to a few more first mortgages with very high rates. In May, the Federal Reserve also announced that it would require the collection of annual percentage rates on most high-cost home loans, although the data collection was disappointingly postponed until January 2004, meaning nothing will be publicly available until mid-2005.

As mentioned above, two major subprime lenders – Household and The Associates – have been forced into huge predatory lending settlements after extensive investigations by the state attorneys general[14] and the Federal Trade Commission. The Household settlement's two-year limit on prepayment penalties and the hundreds of millions of dollars in payouts coming from these subprime lending giants are clearly breakthroughs. But at the same time, many of their abusive practices remain in place, and the settlement amounts for individual borrowers will fall far short of how much wealth was stolen from families by these multi-billion dollar corporations, let alone providing any punitive damages, and will offer little solace to the countless Household and Associates borrowers who have already lost their homes.[15] And of course, a substantial number of other subprime lenders and brokers have also engaged in widespread abuses without serious investigations into their business practices ever having been conducted.

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[13] "Equity Strippers," Pennsylvania ACORN, May 2000; "Preying on Neighborhoods," National Training and Information Center, September 1999; "Unequal Burden in Baltimore," HUD, May 2000; "The Expanding Role of Subprime Lending in Ohio's Burgeoning Foreclosure Problem," Ohio Community Reinvestment Project, October 2002.

[14] A group of 20 state attorneys general began their joint investigation into Household's lending practices within a year of ACORN launching a nation-wide effort in the summer of 2001 to file hundreds of consumer complaints with state AGs and state banking commissioners against the company. See http://www.naag.org/issues/20021011-multi-household.php.

[15] To put these dollar amounts in context, Citigroup CEO Sandy Weill received $523 million in compensation from 1999 through 2001. A more accurate estimate of the actual direct damage inflicted by Household and Beneficial's predatory lending abuses on home loans would range to around $8 billion. On Household's practices, see "Home Wrecker", *Forbes*, by Bernard Condon, September 2, 2002; and Washington [State] Department of Financial Institutions report on Household's predatory lending practices, April 30, 2002.

While the settlements were on-balance positive, their limitations demonstrate the need for strong legislative protections in the subprime market. State legislatures and city councils around the country continue to debate anti-predatory lending bills, with victories of varying levels being won in just over the past year in Georgia, New York City and State, California, and Oakland. On the federal level, the Senate Banking Committee in the 107th Congress, under the leadership of Chairman Paul Sarbanes (D-MD), held a number of major hearings on predatory lending. Senator Sarbanes and Rep. John LaFalce, Ranking Democrat of the House Financial Services Committee, also introduced comprehensive anti-predatory lending legislation in the 107th Congress, S. 2438 and HR 1051.

While much of the financial industry has desperately tried to hold off legislation through a combination of announcing insufficient "best practice" standards, hiring high-paid lobbyists, and making large campaign contributions, the actual experience with legislation has been that it works without reducing access to credit. North Carolina Governor Michael Easley recently announced that the state's 1999 law had saved homeowners $100 million while borrowers with incomes below $25,000 received a higher share of subprime loans than in any other state in the country.[16] Meanwhile, a huge fight looms in Congress as segments of the financial industry view the Republican takeover of the Senate as an opportunity to preempt state and local consumer protections against predatory lending without setting any new, meaningful safeguards for homeowners at the federal level.[17] The fate of our country's gains in homeownership over the last couple decades among people of color and low- and moderate-income Americans hang in the balance.

[16] *North Carolina's Subprime Home Loan Market After Predatory Lending Reform*, prepared by The Center for Responsible Lending, Durham, NC, August 13, 2002. See also "Predatory loan crackdown won't ruin the business; City, state laws raise howls of protest, but experience suggests limited impact," *Craine's New York Business*, by Heike Wipperfurth, October 21, 2002, p. 4; "Surprisingly Strong Subprime Growth," Morgan Stanley, by Kenneth Posner and Athina Meehan, July 31, 2002.
[17] "GOP Rout Means a Change in Committees," *National Mortgage News*, by Brian Collins, Nov. 11, 2002, p. 2.

SUMMARY OF FINDINGS

Subprime Refinance Loans[18]

• Minorities are much more likely than whites to receive a subprime loan when refinancing. In 2001, more than one out of four, 27.76% of all conventional refinance loans received by African-American homeowners were from subprime lenders, as were 13.60% of the refinance loans received by Latino homeowners, compared to 6.32% of the refinance loans received by white homeowners. In comparative terms, African-Americans were 4.4 times more likely to receive a subprime loan, and Latinos were 2.2 times more likely to do so.

• The concentration of subprime loans is greatest among lower income minorities. Nearly half of the refinance loans received by low and moderate income African-American homeowners were from subprime lenders. Subprime lenders accounted for 41.74% of the refinance loans made to low-income African-American homeowners and 33.95% of the refinance loans made to moderate-income African-American homeowners. More than one in six refinance loans made to low and moderate income Latinos was subprime. Subprime lenders accounted for 17.97% of the refinance loans made to low-income Latino homeowners and 17.06% of the refinance loans made to moderate income Latino homeowners.

• The racial disparity remains if we compare minority homeowners with white homeowners of the same income, and it persists among higher income homeowners. 18.05% of the conventional refinance loans received by upper-income African-American homeowners were from subprime lenders, as were 10.06% of the refinance loans received by upper-income Latino homeowners. In contrast, only 4.81% of the refinance loans received by upper-income white homeowners were from subprime lenders. In addition, upper-income African-American homeowners were more likely than low-income white homeowners to receive a subprime loan when refinancing.

• Subprime lenders also target lower income white homeowners. Subprime lenders made 11.76% of all conventional refinance loans received by low-income white homeowners and 8.98% of all refinance loan received by moderate-income white homeowners. In contrast, subprime lenders made just 4.81% of the refinance loans to upper-income white homeowners.

• Minorities receive a larger share of subprime refinance loans than of prime refinance loans. In 2001, African-Americans received 9.43% of all the subprime refinance loans made in the United States, a 3.3 times larger share than the 2.83% of prime refinance loans they received. Latinos received 6.65% of the subprime refinance loans, a 1.4 times greater share than the 4.88% of prime refinance loans they received. In contrast, whites received 41.70% of the subprime refinance loans, but a much greater 71.27% of prime refinance loans.

• There is a greater concentration of subprime loans in minority neighborhoods. Subprime lenders represent nearly one-third, 32.44%, of the refinance loans made in neighborhoods where minorities constitute 80-100% of the population. In 50-80% minority communities, one out of five refinance loans, 19.40%, were from subprime lenders. In contras, less than one in eleven refinance loans 8.51% were from subprime lenders in heavily white communities (0-20% minority population.).

[18] Throughout this report, "refinance loans" refers to conventional refinance loans and does not include government-backed refinance loans.

In comparative terms, homeowners in 80-100% minority communities were 3.8 times more likely to receive a subprime refinance loan than homeowners in heavily white communities (0-20% minority population).

Subprime Purchase Loans

• **African-American homebuyers were 3.6 times more likely than white homebuyers to receive a subprime loan, and Latinos were twice as likely to do so.** Of the conventional prime and subprime purchase loans originated in 2001, subprime loans made up 25.49% of the loans received by African-Americans and 14.55% of the loans to Latinos, but just 7.14% of the loans to whites.

• **Minorities Receive a Much Larger Share of Subprime Purchase Loans Than of Prime Conventional Loans.** In 2001, African-Americans received 12.21% of all the subprime purchase loans made in the United States, a 3.5 times larger share than the 3.51% they received of prime purchase loans. Latinos received 11.51% of the subprime loans, 1.7 times their 6.6% share of prime loans. In contrast, whites received slightly more than half, 55.80%, of the subprime purchase loans, but nearly three quarters, 71.36%, of the prime loans.

• **The rate of growth of subprime lending has been much faster than the rate of growth of prime lending, especially to African-American borrowers.** The number of subprime purchase loans to African-American homebuyers has risen 686% from 1995 to 2001, while the number of prime conventional purchase loans received by African-American homebuyers in 2001 decreased 6% from 1995. Subprime purchase loans increased 882% to Latino homebuyers during this time, while prime loans rose 65%. White homebuyers also saw a larger percentage increase in subprime loans than in prime loans during this time, a 415% increase in the number of subprime loans compared to a 7.8% increase in the number of prime loans.

PREDATORY LENDING AND REFINANCING

The vast majority of subprime loans are for refinances, rather than purchases, and a significant number of predatory practices are linked to refinances. Subprime loans are usually not the traditional refinance in which homeowners seek to lower their interest rate or lock-in at a fixed rate. Subprime refinances are most often promoted for debt consolidation or in order to provide money for home improvements or other household or personal needs.

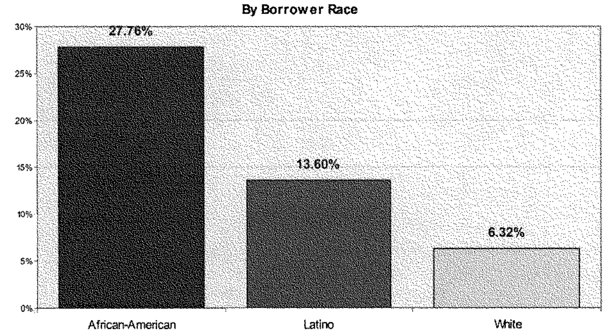
There are circumstances where refinancing to use some of the equity in one's home makes sense for the borrower, but cash-out refinances are rife with potential for abuse by predatory lenders, and too often homeowners with significant amounts of equity are convinced to refinance under conditions that are not in their best interest. In some cases, homeowners are sold refinance loans which produce just a few thousand dollars in cash-out, but which refinance their existing mortgages at higher rates and with high fees. In other cases, homeowners roll debt that is not secured by their house, such as credit cards or car loans, into a mortgage which is secured by their house. This may provide the homeowner with a short term reduction in total monthly obligations, although often it does not even accomplish this because of the high interest rates and fees. In addition, cash-out refinances increase the amount of debt tied to the borrower's house, as well as frequently extending the length of the loan and the total amount of payments. And now if a family is unable to make the payment they will lose their house.

Predatory lenders use refinancing as an opportunity to strip homeowners of their equity by financing thousands of dollars in unnecessary fees and costly credit insurance in the loan. They then add insult to injury by including harmful prepayment penalties in these high-interest refinance loans. More than two-thirds of subprime loans have prepayment penalties, compared to less than 2% of conventional prime loans.[19] It is not uncommon for subprime lenders to make loans at 12%-14% interest rates with prepayment penalties lasting from three to five years that require the borrower to pay six months interest on the loan as a penalty for refinancing with another lender to get a lower interest rate. On a $100,000 loan at 11% interest, such a penalty would cost a borrower over $5,000.

[19] HUD-Treasury report on Predatory Lending, p. 90.

Subprime Refinance Loans[20]

In 2001, 27.76% of all refinance loans received by African-American homeowners were from subprime lenders, as were 13.60% of refinance loans received by Latino homeowners, compared to 6.32% of the refinance loans received by whites. In comparative terms, African-American homeowners were 4.4 times more likely than white homeowners to receive a subprime loan while Latinos were 2.2 times more likely to do so.

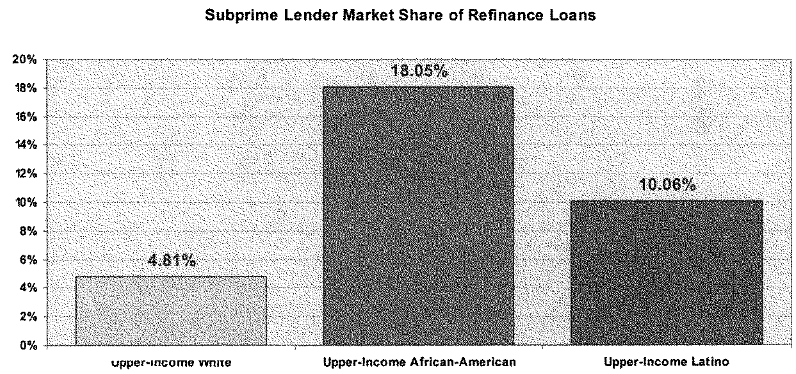


The racial disparity remains when we compare minority borrowers with white borrowers of similar income levels, and it persists among upper-income borrowers. 18.05% of the refinance loans received by upper-income African-Americans were from subprime lenders, as were 10.06% of the refinance loans received by upper-income Latinos. In contrast, only 4.81% of the refinance loans received by upper-income whites were from subprime lenders.[21]

Subprime Lender Market Share of Refinance Loans by Borrower Race and Income

	African-American	Latino	White
Low-Income	41.74%	17.97%	11.76%
Moderate-Income	33.95%	17.06%	8.98%
Middle-Income	27.35%	15.39%	6.78%
Upper-Income	18.05%	10.06%	4.81%

[20] Throughout this report "refinance loans" refers to conventional refinance loans and does not include government-backed refinance loans.
[21] Upper income is defined as earning more than 120% of the area median income. Middle income is defined as earning 80-119% of the area median income. Moderate income is defined as earning 50-79% of the area median income. Low income is defined as earning less than 50% of the area median income.



In comparative terms, upper-income African-Americans were 3.8 times more likely than upper-income whites to receive a subprime loan when refinancing, and upper-income Latinos were 2.1 times more likely. Worse yet, upper-income African-American homeowners were more likely than low-income whites to receive a subprime loan when refinancing.

The concentration of subprime loans is greatest among lower-income minority homeowners. More than two-fifths, 41.74%, of the refinance loans received by low-income African-American homeowners were from subprime lenders as were 33.95% of the refinance loans received by moderate-income African-Americans. More than one out of six, 17.97%, of the refinance loans received by low-income Latinos were from subprime lenders as were 17.06% of the subprime refinance loans received by moderate-income Latinos.

Lower-income white homeowners also receive a greater portion of subprime loans compared to upper-income white homeowners. Subprime lenders made 11.76% of all the refinance loans made to low-income white homeowners, and 8.98% of all the refinance loans made to moderate-income white homeowners. In contrast, subprime lenders made just 4.81% of the subprime loans made to upper-income white homeowners. This means that low-income owners who refinanced were 2.4 times more likely than upper-income white homeowners to receive a subprime loan and moderate-income whites were 1.9 times more likely than upper-income whites.

There is a greater concentration of subprime loans in minority neighborhoods. Subprime lenders represent nearly one-third, 32.44%, of the refinance loans made in neighborhoods where minorities constitute 80-100% of the population. In 50-80% minority communities, one out of five refinance loans, 19.40%, were from subprime lenders. In contrast, less than one in eleven refinance loans, 8.51%, were from subprime lenders in heavily white communities (0-20% minority population). In comparative terms, homeowners in 80-100% minority communities were 3.8 times more likely to receive a subprime refinance loan than homeowners in heavily white communities (0-20% minority population).

Subprime Lender Share of Refinance Loans by Census Tract % Minority

	0-20% Minority	20-50% Minority	50-80% Minority	80-100% Minority
Subprime Lender Loans	431,208	140,235	60,935	59,154
Prime Lender Loans	4,633,651	916,026	253,117	123,180
% Subprime	8.51%	13.28%	19.40%	32.44%

In comparative terms, homeowners in neighborhoods with 80-100% minority population were 3.8 times more likely than homeowners in heavily white neighborhoods (0-20% minority) to receive a subprime loan when refinancing. Homeowners in neighborhoods with 50-80% minority population were still 2.3 times more likely to receive a subprime loan when refinancing than homeowners in heavily white neighborhoods.

Subprime Refinance Lending in Specific Metropolitan Areas

Greatest and Least Concentrations of Subprime Loans[22]

Greatest Concentration of Subprime Refinance Loans to African-American Homeowners

In 41 cities of our study, at least one out of four refinance loans received by African-Americans were from subprime lenders. The cities where subprime loans were the greatest share of refinance loans to African-Americans were: Houston, Cleveland, Kansas City, San Antonio, Jacksonville, Toledo, Memphis, Miami, Pittsburgh and Detroit.

MSA		Subprime Lender Loans	Prime Lender Loans	% Subprime
Houston	TX	1295	1616	44.49%
Cleveland	OH	1651	2311	41.67%
Kansas City	MO	837	1237	40.36%
San Antonio	TX	128	200	39.02%
Jacksonville	FL	459	720	38.93%
Toledo	OH	325	532	37.92%
Memphis	TN	1086	1895	36.43%
Miami	FL	918	1617	36.21%
Pittsburgh	PA	281	526	34.82%
Detroit	MI	5564	10621	34.38%

Least Concentration of Subprime Loans to African-American Homeowners

In all the cities examined, at least one out of seven refinance loans to African-Americans were from subprime lenders. In only 11 cities did subprime lenders represent less than 20% of the refinance loans made to African-American homeowners.

MSA		Subprime Lender Loans	Prime Lender Loans	% Subprime
Baltimore	MD	668	2687	19.91%
Boston	MA	569	2295	19.87%
San Francisco	CA	215	886	19.53%
Hartford	CT	124	511	19.53%
Bergen-Passaic	NJ	132	586	18.38%
San Jose	CA	195	869	18.33%
Orange County	CA	152	761	16.65%
Lake Charles	LA	36	187	16.14%
Seattle	WA	250	1332	15.80%
Stamford-Norwalk	CT	46	248	15.65%
Washington	DC	1695	9671	14.91%

[22] All rankings exclude cities where there were fewer than 50 refinance loans made to African-Americans or Latinos. Excluded from rankings with African-American homeowners are: Sioux Falls, SD, and Las Cruces, NM. Excluded from rankings with Latino refinance loans are: Sioux FallsSD; Pine Bluff, AR; Houma, LA; and Lake Charles, LA.

Greatest Concentration of Subprime Loans to Latino Homeowners

Subprime lenders represented at least one out of five of the refinance loans made to Latinos in five cities in this report. The cities where subprime loans represented the greatest share of refinance loans to Latinos were: San Antonio, Providence, Phoenix-Mesa, Pittsburgh, Brockton, Denver, Cleveland, Houston, Waterbury, and Ft. Wayne.

MSA		Subprime Lender Loans	Prime Lender Loans	% Subprime
San Antonio	TX	966	2196	30.55%
Providence	RI	104	354	22.71%
Phoenix-Mesa	AZ	2138	7494	22.20%
Pittsburgh	PA	38	134	22.09%
Brockton	MA	29	115	20.14%
Denver	CO	1739	7243	19.36%
Cleveland	OH	152	637	19.26%
Houston	TX	1094	4685	18.93%
Waterbury	CT	14	62	18.42%
Ft. Wayne	IN	32	149	17.68%

Least Concentration of Subprime Refinance Loans to Latino Homeowners

At least one in ten refinance loans to Latinos were from subprime lenders in all but 11 cities in this report. The cities were subprime lenders were the smallest share of refinance loans to Latinos were: Atlanta, Seattle, Tampa-St. Petersburg, Las Cruces, Memphis, St. Louis, Washington (DC), Columbus, Baltimore, Milwaukee, Little Rock and Seattle.

MSA		Subprime Lender Loans	Prime Lender Loans	% Subprime
Atlanta	GA	167	1663	9.13%
Seattle	WA	133	1325	9.12%
Tampa-St. Petersburg	FL	366	3685	9.03%
Las Cruces	NM	67	704	8.69%
Memphis	TN	8	86	8.51%
St. Louis	MO	65	456	8.43%
Washington	DC	345	4072	7.81%
Columbus	OH	17	220	7.17%
Baltimore	MD	31	432	6.70%
Milwaukee	WI	67	1005	6.25%
Little Rock	AR	2	59	3.28%

Greatest Concentration of Subprime Loans to White Homeowners

Although subprime lenders represent a smaller share of the refinance loans made to white homeowners, they still represented at least one out of eleven loans in 12 of the cities in this report. The cities where subprime lenders represented the largest share of refinance loans to white homeowners were: San Antonio, Riverside-San Bernardino, St. Louis, Stockton-Lodi, Pine Bluff, San Diego, Houston, Nassau-Suffolk, Wilmington, and Ft. Worth-Arlington.

MSA		Subprime Lender Loans	Prime Lender Loans	% Subprime
San Antonio	TX	705	5384	11.58%
Riverside-San Bernardino	CA	4472	36279	10.97%
St. Louis	MO	3360	67549	10.87%
Stockton-Lodi	CA	1032	9226	10.06%
Pine Bluff	AR	31	283	9.87%
San Diego	CA	6435	59154	9.81%
Houston	TX	2470	23550	9.49%
Nassau-Suffolk	NY	3620	34598	9.47%
Wilmington	DE	747	7157	9.45%
Ft. Worth-Arlington	TX	1397	13402	9.44%

Least Concentration of Subprime Loans to White Homeowners

Subprime lenders represented fewer than one out of 20 refinance loans to white homeowners in 12 cities. The cities where subprime lenders represent the smallest share of subprime loans to white homeowners were: Hartford, Houma, Chicago, Boston, Springfield (Mass.), Stamford-Norwalk, Sioux Falls, Washington (DC), Las Cruces, and Milwaukee.

MSA		Subprime Lender Loans	Prime Lender Loans	% Subprime
Hartford	CT	858	18134	4.52%
Houma	LA	134	2945	4.35%
Chicago	IL	7838	178029	4.22%
Boston	MA	3980	92638	4.12%
Springfield	MA	325	7837	3.98%
Stamford-Norwalk	CT	330	8012	3.96%
Sioux Falls	SD	170	4243	3.85%
Washington	DC	3340	84391	3.81%
Las Cruces	NM	29	1076	2.62%
Milwaukee	WI	949	43163	2.15%

Greatest Concentration of Subprime Loans to Minority Neighborhoods (80-100% Minority Population)[23]

In 15 cities in our study, subprime lenders represented over half the refinance loans made in minority neighborhoods. In 51 cities, subprime lenders represented at least one out of every four refinance loans in minority neighborhoods. The cities where subprime lenders represented the largest share of refinance loans in minority neighborhoods were: Toledo, Kansas City, Orlando, Wilmington, Little Rock, San Antonio, Dallas, Pittsburgh, Houston, and Jacksonville.

MSA		Subprime Lender Loans	All Lender Loans	% Subprime
Toledo	OH	178	285	62.46%
Kansas City	MO	690	1114	61.94%
Orlando	FL	167	286	58.39%
Wilmington	DE	123	215	57.21%
Little Rock	AR	85	149	57.05%
San Antonio	TX	725	1287	56.33%
Dallas	TX	534	959	55.68%
Pittsburgh	PA	287	517	55.51%
Houston	TX	1234	2291	53.86%
Jacksonville	FL	332	624	53.21%

Least Concentration of Subprime Loans to Minority Neighborhoods (80-100% Minority Population)

The cities where subprime lenders represented the smallest share of refinance loans in minority neighborhoods were: Riverside-San Bernardino, Albuquerque, Stamford-Norwalk, Washington (DC), Los Angeles-Long Beach, San Jose, Las Cruces, San Francisco, Orange County and Seattle.

MSA		Subprime Lender Loans	Prime Lender Loans	% Subprime
Riverside-San Bernardino	CA	192	880	21.82%
Albuquerque	NM	114	527	21.63%
Stamford-Norwalk	CT	11	52	21.15%
Washington	DC	1017	5236	19.42%
Los Angeles-Long Beach	CA	5822	30602	19.02%
San Jose	CA	684	3604	18.98%
Las Cruces	NM	58	344	16.86%
San Francisco	CA	748	4532	16.50%
Orange County	CA	272	2030	13.40%
Seattle	WA	39	370	10.54%

[23] Excludes cities where fewer than 50 loans were made in census tracts with 80-100% minority population: Sioux Falls, SD; Brockton, MA; Houma, LA; Portland, OR; Waterbury, CT.

Greatest and Least Disparity in Subprime Refinance Lending

Most Disparate MSAs for African-American Homeowners

In every city we studied, African-Americans were at least two times more likely than whites to receive a subprime loan when refinancing. African-Americans were at least three times more likely in 51 cities. The cities with the greatest disparity between subprime lenders share of refinance loans to African-Americans compared to whites were: Milwaukee, Memphis, Springfield (Mass.), Chicago, Houma, Kansas City, Detroit, Minneapolis-St. Paul, Cleveland, and Toledo.

MSA		Subprime Share of Loans to African-Americans	Subprime Share of Loans to Whites	Disparity
Milwaukee	WI	23.63%	2.15%	11.0
Memphis	TN	36.43%	4.89%	7.4
Springfield	MA	29.38%	3.98%	7.4
Chicago	IL	30.92%	4.22%	7.3
Houma	LA	26.62%	4.35%	6.1
Kansas City	MO	40.36%	7.03%	5.7
Detroit	MI	34.38%	6.03%	5.7
Minneapolis-St. Paul	MN	30.15%	5.31%	5.7
Cleveland	OH	41.67%	7.61%	5.5
Toledo	OH	37.92%	6.94%	5.5

Least Disparate MSAs for African-American Homeowners

The cities with the least disparity between the subprime share of loans to African-Americans and share of loans to whites were: Stockton-Lodi, Nassau-Suffolk, Wilmington, San Jose, Portland, Ft. Lauderdale, San Diego, Riverside-San Bernardino, San Francisco, Pine Bluff and Orange County.

MSA		Subprime Share of Loans to African-Americans	Subprime Share of Loans to Whites	Disparity
Stockton-Lodi	CA	28.35%	10.06%	2.8
Nassau-Suffolk	NY	26.91%	9.47%	2.8
Wilmington	DE	26.06%	9.45%	2.8
San Jose	CA	18.33%	6.65%	2.8
Portland	OR	22.30%	8.11%	2.7
Ft. Lauderdale	FL	24.80%	9.40%	2.6
San Diego	CA	24.36%	9.81%	2.5
Riverside-San Bernardino	CA	26.02%	10.97%	2.4
San Francisco	CA	19.53%	8.25%	2.4
Pine Bluff	AR	23.16%	9.87%	2.3
Orange County	CA	16.65%	8.21%	2.0

Most Disparate MSAs for Latino Homeowners

In 32 of the cities examines, Latinos were at least two times more likely to receive a subprime loan than whites. The cities with the greatest disparity between the subprime share of refinance loans to Latinos and the subprime share of loans to whites were: Springfield (Mass.), Providence, Hartford, Boston, Las Cruces, Tucson, Brockton, Milwaukee, Ft. Wayne, Fresno, Stamford-Norwalk and Waterbury.

MSA		Subprime Share of Loans to Latinos	Subprime Share of Loans to Whites	Disparity
Springfield	MA	17.60%	3.98%	4.4
Providence	RI	22.71%	5.88%	3.9
Hartford	CT	15.81%	4.52%	3.5
Boston	MA	13.83%	4.12%	3.4
Las Cruces	NM	8.69%	2.62%	3.3
Tucson	AZ	15.78%	5.09%	3.1
Brockton	MA	20.14%	6.64%	3.0
Milwaukee	WI	6.25%	2.15%	2.9
Ft. Wayne	IN	17.68%	6.20%	2.9
Fresno	CA	16.34%	5.68%	2.9
Stamford-Norwalk	CT	11.60%	3.96%	2.9
Waterbury	CT	18.42%	6.35%	2.9

Least Disparate MSAs for Latino Homeowners

Subprime lenders represented a smaller portion of loans to Latinos than of the loans to whites in only two cities in this study: Little Rock and St. Louis. In nine cities, the disparity was less than 1.5 times: Jacksonville, Baltimore, Stockton-Lodi, Portland, Riverside-San Bernardino, Tampa-St. Petersburg, Ft. Lauderdale, Columbus, and Baton Rouge.

MSA		Subprime Share of Loans to Latinos	Subprime Share of Loans to Whites	Disparity
Jacksonville	FL	10.83%	7.61%	1.4
Baltimore	MD	6.70%	4.72%	1.4
Stockton-Lodi	CA	13.81%	10.06%	1.4
Portland	OR	11.13%	8.11%	1.4
Riverside-San Bernardino	CA	15.65%	10.97%	1.4
Tampa-St. Petersburg	FL	9.03%	6.77%	1.3
Ft. Lauderdale	FL	11.94%	9.40%	1.3
Columbus	OH	7.17%	5.81%	1.2
Baton Rouge	LA	10.23%	8.36%	1.2
St. Louis	MO	8.43%	10.87%	0.8
Little Rock	AR	3.28%	4.77%	0.7

Most Disparate MSAs for Homeowners in Minority Neighborhoods (80-100% Minority Population)

In 56 cities, subprime lenders made more than two times a greater share of the refinance loans in minority neighborhoods than they did in heavily white neighborhoods (0-20% white population)[24]. The cities with the greatest disparity were: Milwaukee, Springfield (Mass.), St. Louis, Minneapolis-St. Paul, Toledo, Little Rock, Detroit, Hartford, Kansas City, Chicago.

MSA		Subprime Share of Refinance Loans		Disparity
		80-100% Minority Population	0-20% Minority Population	
Milwaukee	WI	43.93%	3.20%	13.7
Springfield	MA	52.86%	6.86%	7.7
St. Louis	MO	51.44%	7.25%	7.1
Minneapolis-St. Paul	MN	45.60%	6.40%	7.1
Toledo	OH	62.46%	9.11%	6.9
Little Rock	AR	57.05%	8.43%	6.8
Detroit	MI	46.99%	6.96%	6.8
Hartford	CT	47.94%	7.31%	6.6
Chicago	IL	32.77%	4.96%	6.6
Kansas City	MO	61.94%	9.57%	6.5

Least Disparate MSA for Homeowners in Minority Neighborhoods

The cities with the least disparity between the subprime lender share of refinance loans in minority neighborhoods (80-100% minority) and white neighborhoods (0-20% minority) were: Jersey City, San Diego, Stockton-Lodi, Los Angeles-Long Beach, Pine Bluff, Riverside-San Bernardino, San Francisco, Albuquerque, Orange County, and Seattle.

MSA		Subprime Share of Refinance Loans		Disparity
		80-100% Minority Population	0-20% Minority Population	
Jersey City	NJ	27.27%	8.95%	3.0
San Diego	CA	25.88%	9.15%	2.8
Stockton-Lodi	CA	28.54%	10.55%	2.7
Los Angeles-Long Beach	CA	19.02%	8.32%	2.3
Pine Bluff	AR	40.38%	18.38%	2.2
Riverside-San Bernardino	CA	21.82%	11.36%	1.9
San Francisco	CA	16.50%	8.54%	1.9
Albuquerque	NM	21.63%	12.07%	1.8
Orange County	CA	13.40%	8.36%	1.6
Seattle	WA	10.54%	6.55%	1.6

[24] Excludes cities where fewer than 50 loans were made in census tracts with 80-100% population as well as cities where fewer than 50 loans were made in census tract with 0-20% minority population: Sioux Falls, SD; Brockton, MA: Houma, LA: Portland, OR: Waterbury, CT; Las Cruces, NM.

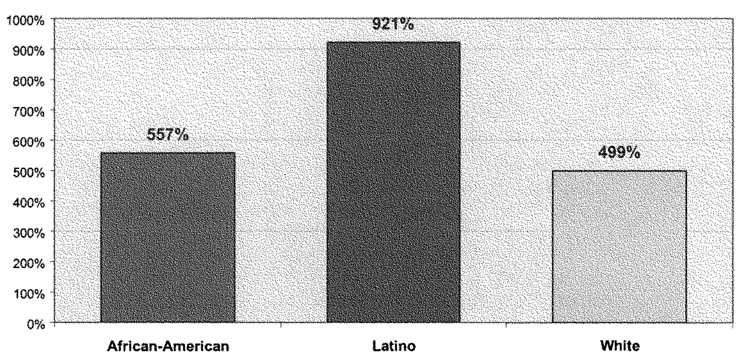
The Growth of Subprime Refinance Loans

In 1993, subprime lenders made almost 80,000 home refinance loans. In 2001, subprime lenders made over 700,000 refinance loans – almost nine times more than in 1993.

Growth from 1993 to 2001 in Home Refinance Loans

Race	Subprime			Prime		
	1993	2001	Change	1993	2001	Change
African-American	9,747	66,052	+577%	150,597	171,899	+14%
Latino	4,565	46,624	+921%	193,377	296,145	+53%
White	48,763	292,182	+499%	4,957,388	4,328,768	-13%

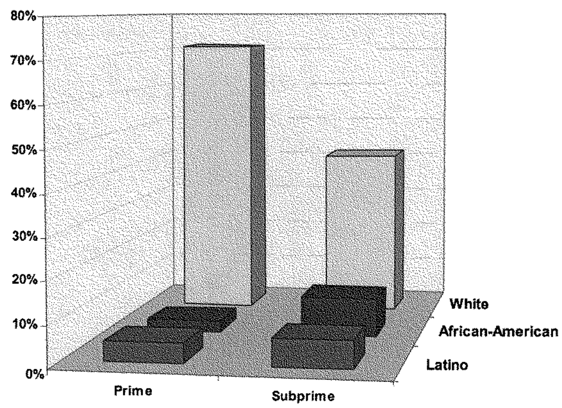
Growth in Subprime Refinance Lending by Borrower Race 1993-2001



Minorities Receive a Larger Share of Loans Made by Subprime Lenders Than of Prime Lenders

In 2001, African-Americans received 15.37% of all the refinance loans made by subprime lenders where the borrower's race was indicated, and 3.38% of the loans by prime lenders where borrower race was indicated, a 4.5 times difference. Latinos received 10.85% of all the refinance loans by subprime lenders, a 2.1 times greater share than the 5.82% they received of the refinance loans made by prime lenders where borrower race was indicated. In comparison, white homeowners received 67.99% of the subprime loans where borrower race was indicated but an even greater 85.20% of the loans by prime lenders.

Share of Refinance Loans by Lender Type and Borrower Race



Race Not Available for Subprime Refinance Loans

While there has been a large increase in the number of all types of mortgages reported with 'Race Not Available or Unknown' an especially large number of refinance loans, and subprime refinance loans in particular, are reported without the borrower's race.

Nationally, 38.7% of the refinance loans made by subprime lenders were reported without the borrower's race – well over twice as much as the 16.4% of refinance loans made by prime lenders which were reported without the borrower's race. While subprime lenders accounted for 10.3% of the total refinance loans made in the country last year, they made 21.4% of the refinance loans on which the borrower's race was not indicated.

This 'silence' about race on many loans means that the data reported here most likely understates the actual concentration of subprime lending to minority borrowers. There is no reason to believe that the distribution of refinance loans on which no race is indicated is different from that of loans where the race of the borrower is recorded. Thus, when the data including race tells us that 28 percent of refinance loans to African American borrowers are from subprime lenders, it is likely that more of the race unrecorded subprime than prime loans went to African American borrowers, and the actual portion of all refinance loans to African American borrowers from subprime lenders is greater than 28%. This proposition is supported by the fact that data on the concentration of subprime lending by neighborhood characteristic, which is not vulnerable to this silence, reveals still greater levels of concentration than the data on borrower characteristics.

It is unfortunate for a large and increasing portion of the data crucial to understanding lending patterns to be obscured in this way, particularly since we do not believe that there is any practical barrier to recording the race of the borrower in many instances where it is not in fact recorded – far fewer than 34.9% of subprime refinance loans take place without face to face contact.

In sixty-six of the sixty-seven metropolitan areas examined in this report, at least one in every five subprime refinance loans were reported with no race indicated. In contrast, at least 20% of prime refinance loans were reported without the borrower's race in just twenty-six of the sixty-seven metropolitan areas. In over half of the sixty-seven metropolitan areas, more than one-third of the subprime refinance loans had no race for the borrower and over 50% of the subprime refinance loans had no borrower race indicated in thirteen of the metropolitan areas examined.

The ten metropolitan areas in which the largest percentage of the subprime refinance loans were recorded with "Race Not Available" were: Pittsburgh, PA (60.6% race not available); Pine Bluff, AR (58.9%); Lake Charles, LA (55.1%); Las Cruces, NM (52.9%); Columbus, OH (52.8%); Little Rock, AR (52.6%); Hartford, CT (52.5%); Philadelphia, PA (52.3%); Waterbury, CT (52.3%); Houma, LA (51.6%).

The ten metropolitan areas in which the smallest percentage of the subprime refinance loans were recorded with "Race Not Available" were: San Francisco, CA (18.1%); San Jose, CA (20.4%); Chicago, IL (21.7%); San Diego, CA (22.7%); Los Angeles-Long Beach, CA (23.6%); Orange County, CA (25.0%); Denver, CO (26.0%); Oakland, CA (26.9%); Portland, OR (27.0%); Phoenix-Mesa, AZ (27.7%).

The ten areas which had the greatest difference between the percentage of prime refinance loans reported as "Race Not Available" and the percentage of subprime refinance loans reported as "Race Not Available" were: Washington, DC (82.0%); Columbus, OH (42.8%); Pittsburgh, PA (33.4%); New Orleans, LA (24.5%); Providence, RI (23.8%); Memphis, TN (21.6%); Jacksonville, FL (21.4%); Hartford, CT (21.00%); New Haven, CT (20.9%); Bridgeport, CT (20.8%).

The ten metropolitan areas which had the least difference between the percentage of subprime refinance loans reported as "Race Not Available or Unknown" and the percentage of prime refinance loans reported as "Race Not Available or Unknown" were: Houma, LA (0.9%); Portland, OR (6.9%); Albuquerque, NM (7.7%); Miami, FL (7.8%); Pine Bluff, AR (9.4%); Chicago, IL (9.5%); Tucson, AZ (9.8%); San Antonio, TX (10.0%); Seattle, WA (10.2%); Detroit, MI (10.3%).

As part of the Federal Reserve's revisions this year to HMDA, mortgage lenders will be required to inquire about the race of telephone applicants, beginning with the data collected in 2003.[25]

[25] For a full explanation of the Federal Reserve's HMDA changes, see the February 7, May 2, and June 21 news releases at http://www.federalreserve.gov/boarddocs/press/bcreg/2002/.

PREDATORY LENDING AND HOMEBUYING

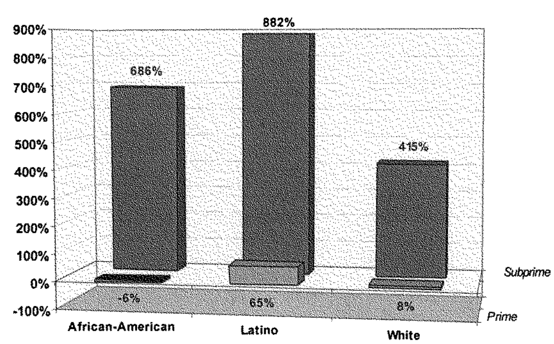
The Growth of Subprime Purchase Loans

While refinance loans make up the greatest portion of subprime lending, subprime lenders are increasing their share of the home purchase market. In 1993, subprime lenders made just 24,000 home purchase loans, which represented 1% of all the conventional home purchase loans made in the country.[26] In 2001, subprime lenders increased that number by twelve times to over 297,000 home purchase loans, or 9.0% of all the conventional home purchase loans. Unlike subprime refinance lending, which slightly declined from 1999 to 2001, subprime purchase lending continued to grow, rising from 2000 to 2001 as well.

While all communities experienced this increase in the number of subprime purchase loans, the growth in subprime lending to minorities has been greater than for whites and has been especially steep since 1995. The number of subprime purchase loans to African-American homebuyers has risen 686% from 4,614 loans in 1995 to 36,285 loans in 2001. The number of prime conventional purchase loans received by African-American homebuyers in 2001 was 6% *less* than the number received in 1995. Subprime purchase loans increased 882% to Latino homebuyers during this time, while prime loans rose just 65%. White homebuyers also saw a larger percentage increase in subprime loans than in prime loans – a 415% increase in the number of subprime loans and an 8% increase in the number of prime loans.

	Prime Lender Loans			Subprime Lender Loans		
	1995	2001	Change	1995	2001	Change
African-American	112,463	106,076	-6%	4,614	36,285	+686%
Latino	121,457	200,848	+65%	3,483	34,207	+882%
White	2,001,711	2,157,570	+8%	32,224	165,829	+415%

Change in Conventional Purchase Lending by Lender Type and Bororwer Race 1995-2001



[26] Schessele, Randall M. 1999, 2000, 2001. U.S. Department of Housing and Urban Development.

Subprime Loans as a Percentage of Conventional Purchase Loans[27]

Purchase loans for manufactured housing make up a larger percentage of conventional loans received by African-Americans and Latinos than of those received by whites. Subprime loans made up 25.5% of conventional home purchase loans received by African-Americans in 2001 and 14.6% of the conventional home purchase loans to Latinos, but just 7.1% of the loans to whites.

Percentage of Conventional Purchase Loans That Are from Subprime Lenders

Race	1993	1995	1999	2001
African-Americans	2.7%	3.9%	23.1%	25.5%
Latinos	1.6%	2.8%	12.0%	14.6%
Whites	0.8%	1.6%	4.8%	7.1%

In comparative terms, this means that in 2001, African-American homebuyers were 3.6 times more likely than white homebuyers to receive a subprime loan and Latinos were 2.0 times more likely to receive a subprime loan than white homebuyers.

The racial disparity remains when comparing minority borrowers with white borrowers of the same income. 18.93% of the conventional purchase loans received by upper-income African-Americans were from subprime lenders, as were 12.71% of the conventional purchase loans received by upper-income Latinos. In contrast, only 5.84% of the purchase loans received by upper-income whites were from subprime lenders.

This means that upper-income African-American homebuyers were 3.2 times more likely to receive a subprime loan than upper-income white homebuyers and upper-income Latinos were 2.2 times more likely than whites to receive a subprime loan.

In addition, upper-income African-Americans and Latinos were even more likely than low-income whites to receive a subprime loan.

[27] "All Loans" excludes loans made by manufactured housing lenders.

Minorities Receive a Much Larger Share of Home Purchase Loans from Subprime Lenders than from Prime Lenders

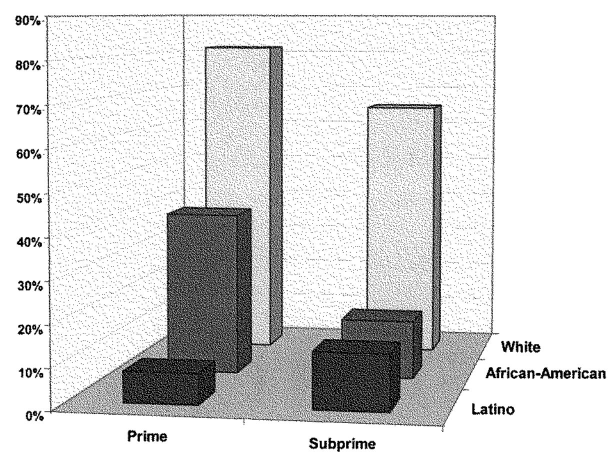
In 2001, African-Americans received 12.21% of all the subprime purchase loans made in the United States, a 3.5 times larger share than the 3.51% of prime purchase loans they received. Latinos received 11.51% of the subprime loans, almost double their 6.64% share of prime loans. In contrast, whites received 55.80% of the subprime purchase loans, but 71.36% of the prime loans.

Share of Subprime Purchase Loans Received

Borrower Race	1993	1995	1999	2001
African-American	8.3%	9.0%	13.5%	12.2%
Latino	5.9%	6.8%	8.5%	11.5%
White	60.5%	62.7%	49.6%	55.8%

If we exclude the loans where no borrower race was indicated (15% of the subprime loans and 12% of the prime lender loans), African-Americans received 14.30% of the subprime loans where race was indicated, 3.6 times greater than the 4.00% they received of the loans by prime lenders where the borrower race was indicated. Latinos received 13.49% of the subprime lender loans, a 1.8 times greater share than the 7.57% they received of the purchase loans by prime lenders. White borrowers received 65.38% of the loans by subprime lenders but 81.32% of the loans by prime lenders.

The share received by African-Americans and Latinos has increased significantly since 1993 while the share received by whites has declined since then.



Subprime Lending in Minority Communities

There is a greater concentration of subprime loans in minority neighborhoods. Subprime lenders represent more than one-fifth, 22.71% of the conventional home purchase loans made in neighborhoods where minorities constitute 80-100% of the population. In 50-80% minority communities, 15.52% were from subprime lenders. In contrast, less than one in thirteen refinance loans 7.42% were from subprime lenders in heavily white communities (0-20% minority population.).

Subprime Lender Share of Refinance Loans by Census Tract % Minority

	0-20% Minority	20-50% Minority	50-80% Minority	80-100% Minority
Subprime Lender Loans	179,779	71,420	24,322	18,367
Prime Lender Loans	2,241,898	506,029	132,372	62,493
% Subprime	7.42%	12.37%	15.52%	22.71%

In comparative terms, homeowners in 80-100% minority communities were 3.1 times more likely to receive a subprime refinance loan than homeowners in heavily white communities (0-20% minority population). Homeowners in neighborhoods with 50-80% minority population were 2.1 times more likely to receive a subprime loan when refinancing than homeowners in heavily white neighborhoods.

Subprime Purchase Lending in Specific Metropolitan Areas

Greatest and Least Concentrations of Subprime Loans

Greatest Concentration of Subprime Purchase Loans to African-American Homebuyers

In every city,[28] subprime lenders represented at least one out of every nine conventional purchase loans made to African-Americans. In 10 cities, subprime lenders made at least one out of every three purchase loans made to African-Americans: Memphis, New Haven, Cleveland, St. Louis, Ft. Wayne, Gary, Riverside-San Bernardino, Indianapolis, Chicago and Detroit.

MSA		Subprime Lender Loans	Prime Lender Loans	% Subprime
Memphis	TN	959	1232	43.77%
New Haven	CT	106	181	36.93%
Cleveland	OH	730	1261	36.66%
St. Louis	MO	890	1538	36.66%
Ft. Wayne	IN	35	65	35.00%
Gary	IN	116	219	34.63%
Riverside-San Bernardino	CA	728	1411	34.03%
Indianapolis	IN	306	596	33.92%
Chicago	IL	2622	5158	33.70%
Detroit	MI	1546	3073	33.47%

Least Concentration of Subprime Purchase Loans to African-American Homebuyers

MSA		Subprime Lender Loans	Prime Lender Loans	% Subprime
Baltimore	MD	427	1945	18.00%
New Orleans	LA	154	721	17.60%
Stamford-Norwalk	CT	32	155	17.11%
Jersey City	NJ	28	138	16.87%
Minneapolis-St. Paul	MN	169	838	16.78%
Washington	DC	1441	7464	16.18%
Bergen-Passaic	NJ	64	332	16.16%
Nassau-Suffolk	NY	220	1279	14.68%
Boston	MA	157	1066	12.84%
New York	NY	638	4782	11.77%

[28] Rankings exclude cities where fewer than 50 conventional purchase loans were made to African-Americans or Latinos. Fewer than 50 purchase loans were made to African-Americans in Sioux Falls, SD; Las Cruces, NM; and Houma, LA. Fewer than 50 purchase loans were made to Latinos in Sioux Falls, SD; Pine Bluff, AR; Houma, LA; Baton Rouge, LA; and Lake Charles.

Greatest Concentration of Subprime Purchase Loans to Latino Homebuyers

MSA		Subprime Lender Loans	Prime Lender Loans	% Subprime
Waterbury	CT	59	93	38.82%
Providence	RI	125	258	32.64%
San Jose	CA	841	2165	27.98%
Portland	OR	183	491	27.15%
New Haven	CT	62	208	22.96%
San Diego	CA	1155	3927	22.73%
San Francisco	CA	326	1141	22.22%
Riverside-San Bernardino	CA	2071	7473	21.70%
Oakland	CA	1069	4093	20.71%
San Antonio	TX	673	2714	19.87%

Least Concentration of Subprime Purchase Loans to Latino Homebuyers

MSA		Subprime Lender Loans	Prime Lender Loans	% Subprime
Indianapolis	IN	19	175	9.79%
New Orleans	LA	26	249	9.45%
Columbus	OH	12	118	9.23%
Ft. Worth-Arlington	TX	183	1833	9.08%
Ft. Wayne	IN	7	71	8.97%
St. Louis	MO	23	235	8.91%
Cincinnati	OH	10	127	7.30%
Cleveland	OH	32	409	7.26%
Milwaukee	WI	49	709	6.46%
Wilmington	DE	7	121	5.47%

Greatest Concentration of Subprime Purchase Loans to White Homebuyers

MSA		Subprime Lender Loans	Prime Lender Loans	% Subprime
Riverside-San Bernardino	CA	4599	22874	16.74%
Los Angeles-Long Beach	CA	6689	42206	13.68%
Stockton-Lodi	CA	540	3500	13.37%
San Diego	CA	3608	23521	13.30%
Portland	OR	3058	20489	12.99%
Pine Bluff	AR	28	196	12.50%
Orange County	CA	3238	24614	11.63%
Oakland	CA	2097	16469	11.29%
San Jose	CA	895	7065	11.24%
San Francisco	CA	1118	8832	11.24%

Least Concentration of Subprime Purchase Loans to White Homebuyers

MSA		Subprime Lender Loans	Prime Lender Loans	% Subprime
Gary	IN	226	4817	4.48%
Indianapolis	IN	663	14814	4.28%
Cleveland	OH	872	20449	4.09%
New York	NY	1224	29721	3.96%
New Orleans	LA	237	6428	3.56%
Minneapolis-St. Paul	MN	1504	41339	3.51%
Bergen-Passaic	NJ	285	7860	3.50%
Stamford-Norwalk	CT	132	3891	3.28%
Newark	NJ	411	12233	3.25%
Milwaukee	WI	391	15688	2.43%

Greatest Concentration of Subprime Purchase Loans to Minority Neighborhoods (80-100% Minority Population)[29]

MSA		Subprime Lender Loans	Prime Lender Loans	% Subprime
Jacksonville	FL	113	77	59.47%
St. Louis	MO	294	268	52.31%
Indianapolis	IN	135	137	49.63%
Cleveland	OH	512	553	48.08%
Toledo	OH	33	36	47.83%
Detroit	MI	892	1006	47.00%
Memphis	TN	239	283	45.79%
Providence	RI	37	44	45.68%
Baton Rouge	LA	38	47	44.71%
New Haven	CT	31	39	44.29%

Least Concentration of Subprime Purchase Loans to Minority Neighborhoods (80-100% Minority Population)

MSA		Subprime Lender Loans	Prime Lender Loans	% Subprime
Sacramento	CA	8	42	16.00%
Houston	TX	334	1780	15.80%
Las Cruces	NM	21	130	13.91%
Bergen-Passaic	NJ	37	240	13.36%
New York	NY	850	5594	13.19%
Stockton-Lodi	CA	52	343	13.16%
Washington	DC	432	2898	12.97%
Ft Worth-Arlington	TX	23	160	12.57%
Boston	MA	84	597	12.33%
Seattle	WA	11	164	6.29%

[29] Excludes cities where fewer than 50 conventional home purchase loans were made in census tracts with 80-100% minority population: Sioux Falls, SD; Brockton, MA; Waterbury, CT; Ft. Wayne, IN; Lake Charles, LA; Little Rock, AR; Houma, LA; Pine Bluff, AR; Stamford-Norwalk, CT; Portland, OR.

Greatest and Least Disparity in Subprime Home Purchase Lending

Most Disparate MSAs for African-American Homebuyers

MSA		Subprime Share of Loans to African-Americans	Subprime Share of Loans to Whites	Disparity
Cleveland	OH	36.66%	4.09%	9.0
Milwaukee	WI	21.28%	2.43%	8.8
Indianapolis	IN	33.92%	4.28%	7.9
Gary	IN	34.63%	4.48%	7.7
Ft. Wayne	IN	35.00%	4.60%	7.6
St. Louis	MO	36.66%	4.89%	7.5
Chicago	IL	33.70%	4.78%	7.1
Jacksonville	FL	32.77%	5.14%	6.4
Memphis	TN	43.77%	7.14%	6.1
Newark	NJ	18.68%	3.25%	5.8

Least Disparate MSAs for African-American Homebuyers

MSA		Subprime Share of Loans to African-Americans	Subprime Share of Loans to Whites	Disparity
Stockton-Lodi	CA	29.47%	13.37%	2.2
Portland	OR	28.19%	12.99%	2.2
Pine Bluff	AR	27.69%	12.50%	2.2
Phoenix-Mesa	AZ	22.14%	10.32%	2.2
Boston	MA	12.84%	5.82%	2.2
Riverside-San Bernardino	CA	34.03%	16.74%	2.0
Los Angeles-Long Beach	CA	27.80%	13.68%	2.0
Orange County	CA	23.74%	11.63%	2.0
San Jose	CA	21.24%	11.24%	1.9
Sacramento	CA	20.80%	10.77%	1.9
San Diego	CA	23.98%	13.30%	1.8
San Francisco	CA	19.00%	11.24%	1.7

Most Disparate MSAs for Latino Homebuyers

MSA		Subprime Share of Loans to Latinos	Subprime Share of Loans to Whites	Disparity
Stamford-Norwalk	CT	17.58%	3.28%	5.4
Waterbury	CT	38.82%	7.93%	4.9
Providence	RI	32.64%	9.03%	3.6
Hartford	CT	18.66%	5.40%	3.5
Minneapolis-St. Paul	MN	11.41%	3.51%	3.3
Newark	NJ	10.57%	3.25%	3.3
Bergen-Passaic	NJ	11.63%	3.50%	3.3
Jersey City	NJ	17.21%	5.34%	3.2
Springfield	MA	17.53%	5.71%	3.1
New Haven	CT	22.96%	7.77%	3.0

Least Disparate MSAs for Latino Homebuyers

MSA		Subprime Share of Loans to Latinos	Subprime Share of Loans to Whites	Disparity
Columbus	OH	9.23%	5.66%	1.6
Dallas	TX	12.04%	7.43%	1.6
Tampa-St. Petersburg	FL	12.10%	7.39%	1.6
Ft. Lauderdale	FL	14.61%	9.04%	1.6
Sacramento	CA	16.03%	10.77%	1.5
Stockton-Lodi	CA	18.19%	13.37%	1.4
Orange County	CA	16.06%	11.63%	1.4
Riverside-San Bernardino	CA	21.70%	16.74%	1.3
Cincinnati	OH	7.30%	6.21%	1.2
Ft. Worth-Arlington	TX	9.08%	7.81%	1.2
Los Angeles-Long Beach	CA	16.61%	13.68%	1.2
Wilmington	DE	5.47%	6.63%	0.8

Most Disparate MSAs for Homebuyers in Minority Neighborhoods (80-100% Minority Population)

MSA		Subprime Share of Refinance Loans		Disparity
		80-100% Minority Population	0-20% Minority Population	
Fresno	CA	20.97%	1.04%	20.2
Indianapolis	IN	49.63%	4.69%	10.6
Jacksonville	FL	59.47%	5.78%	10.3
Milwaukee	WI	27.00%	2.69%	10.0
Cleveland	OH	48.08%	4.95%	9.7
St. Louis	MO	52.31%	6.03%	8.7
Toledo	OH	47.83%	5.54%	8.6
Columbus	OH	41.33%	4.96%	8.3
Newark	NJ	22.92%	3.21%	7.1
Kansas City	MO	38.42%	5.66%	6.8
Minneapolis-St. Paul	MN	27.16%	3.98%	6.8

Least Disparate MSA for Homebuyers in Minority Neighborhoods

MSA		Subprime Share of Refinance Loans 80-100% Minority Population	0-20% Minority Population	Disparity
Phoenix-Mesa	AZ	19.82%	10.55%	1.9
Ft. Lauderdale	FL	19.11%	10.34%	1.8
San Francisco	CA	17.17%	10.62%	1.6
Ft . Worth-Arlington	TX	7.84%	12.57%	1.6
Los Angeles-Long Beach	CA	18.74%	12.53%	1.5
Sacramento	CA	16.00%	10.98%	1.5
Orange County	CA	16.59%	11.57%	1.4
Riverside-San Bernardino	CA	18.05%	17.07%	1.1
Stockton-Lodi	CA	13.16%	11.90%	1.1
Seattle	WA	6.29%	8.70%	0.7

The Exclusion of Low-Income and Minority Neighborhoods from the Economic Mainstream

Predatory lenders have been able to get away with abusive practices in part because they are exploiting the history of racial discrimination and neighborhood redlining by traditional financial institutions.

In October 2002, ACORN released a report entitled *The Great Divide*, which examined 2001 loan data for the nation as a whole, as well as for 68 metropolitan areas. The report found continuing and even growing racial and economic disparities in home purchase mortgage lending. Nationally, African-American mortgage applicants were rejected 2.31 times more often than white applicants, and Latinos were denied 1.53 times more often than whites. Conventional purchase originations to African-Americans fell by 7.8% compared to the previous year. The report also found that while low and moderate income neighborhoods comprise 25.7% of the country, these neighborhoods only received 11.7% of the loans. Furthermore, residents of low and moderate income neighborhoods were 3.1 times more likely to be turned down for a loan than residents of upper-income neighborhoods.[30]

This statistical analysis has been corroborated by a report from the Urban Institute, prepared for HUD, which concluded that minority homebuyers face discrimination from mortgage lenders. The report cited "paired testing" which showed that minorities were less likely to receive information about loan products, received less time and information from loan officers, and were quoted higher interest rates.[31]

The Great Divide also found that many metropolitan areas had much more alarming disparities in their mortgage lending than the national average. For instance, in Chicago and Milwaukee, African-Americans were more than five times more likely than whites to be denied for a conventional loan. As described in this report, when African-American borrowers do receive a loan, their likelihood of receiving a subprime loan relative to white borrowers is also among the highest in the country. African-Americans in Milwaukee were nearly nine times more likely than whites to receive a subprime loan when buying a house with a conventional loan and in Chicago were over seven times more likely.

Banks have for the most part abandoned low-income and minority neighborhoods. A study by economists at the Federal Reserve found that the number of banking offices in low and moderate income areas decreased 21% from 1975 to 1995, while the total number of banking offices in all areas rose 29% during this same period. This is significant because studies have documented that the proximity of a bank's branches to low and moderate income neighborhoods is directly related to the level of lending made by the bank in those neighborhoods.[32]

In 2001, one-quarter of families with incomes below 80% of the area median income did not have a bank account.[33] Having a bank account is a basic, yet important, entry point into the mainstream economy and traditional financial services. A bank account can help a consumer handle their finances, save money, and establish the type of credit which is often a prerequisite to receiving a conventional loan. In addition, having an account establishes a relationship with a bank, which makes it more likely

[30] The report examined applications for conventional home purchase loans. Low and moderate income neighborhoods are defined as census tracts in which the median income is below 80% of the median income for the entire metropolitan area. Upper income neighborhoods are census tracts in which the median income is more than 120% of the area's median income.
[31] "Discrimination in Metropolitan Housing Markets: National Results from Phase I of HDS2000," The Urban Institute, November 2002.
[32] *The Community Reinvestment Act After Financial Modernization: A Baseline Report*, U.S. Treasury Department, April 2000.
[33] *The State of the Nation's Housing: 2001*, Harvard University Joint Center for Housing Studies, p. 29.

that the consumer will contact that bank regarding loans and other services. Furthermore, the consumer will also be contacted by the bank as it markets its other products, such as mortgages, to its existing customer base.[34]

The ten million American families without bank accounts represent a substantial market of consumers who require alternative financial services. In response, a "fringe economy" has emerged made up of check-cashing stores, pawnshops, and payday lenders, which are then able to overcharge lower income consumers. Many of these "shadow banks" are funded by mainstream banks. For instance, Wells Fargo, the seventh largest bank in the country, has arranged more than $700 million in loans since 1998 to three of the largest check cashers: Ace Cash Express, EZ Corp., and Cash America.[35] Payday lenders are also increasingly trying to rent out national bank charters to avoid state consumer protection laws.

The exclusion of low-income and minority communities from traditional banking services has also translated into a lack of the financial knowledge that could help consumers receive loans with more reasonable terms. For instance, a study by Benedict College found that half of African-Americans with good credit ratings were not aware of it.[36]

These factors have created an environment that was ripe to be picked by predatory lenders who aggressively target these underserved communities with a bombardment of mailings, phone calls, and door-to-door solicitations. Sales to the captive audience of the subprime market are driven by inappropriate and deceptive marketing practices that encourage potential borrowers to believe that they have no better credit options for their legitimate credit needs.

While the faces of predatory lenders may appear to be those of small-time crooks, the kingpins behind predatory lending can be found among some of the world's largest financial institutions, and in fact, many of the same institutions which created the situation by their failure to serve certain communities are now opportunistically reaping the profits.

Sometimes these institutions have direct ownership of subprime lending subsidiaries, such as Citigroup and Citifinancial. In 1999, Citifinancial had 1,170 branch offices and recorded a 77% increase in net income to $390 million.[37] This was prior to its acquisition of Associates, the nation's largest consumer lender, which had 1,300 branches of its own branches in the U.S. and in 1999 had $1.5 billion in profits, its 25th consecutive year of record earnings. In other cases, these institutions, particularly investment firms, bankroll predators by securitizing their mortgages and selling them to investors. The major Wall Street investment banks' involvement in the subprime market has grown substantially in recent years, securitizing $18.5 billion in subprime loans in 1997 up to $56 billion in 2000.[38]

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34 *The Community Reinvestment Act After Financial Modernization: A Baseline Report*, U.S. Treasury Department, April 2000..
35 "Easy Money," *Business Week*, April 24, 2000.
36 *The State*, February 22, 2000.
37 "Easy Money," *Business Week*, April 24, 2000.
38 "Predatory Lending Document Could Target CitiFinancial," *Dallas Morning News*, by Anuradha Raghunathan, September 13, 2002, Business section.

Many Borrowers in Subprime Loans Should Have Qualified for a Lower Cost Loan

The fact that a part of the boom in subprime lending, especially to minorities, results from the neglect of certain communities by 'A' lenders is further underlined by the considerable evidence that many borrowers in subprime loans could have qualified for 'A' loans at lower rates.

Franklin Raines, the Chairman of Fannie Mae, has stated that as many as half of all borrowers in subprime loans could have instead qualified for a lower cost conventional mortgage, which according to Raines, could save a borrower more than $200,000 over the life of a thirty year loan.[39]

This conclusion is supported by other sources. *Inside Mortgage Finance* published a poll of the 50 most active subprime lenders which also found that up to 50 percent of their mortgages could qualify as conventional loans.[40] Freddie Mac has estimated that as many as 35 percent of borrowers who obtained mortgages in the subprime market could have qualified for a lower cost conventional loan.[41] In an investigation of subprime lenders, the Department of Justice found that approximately 20% of the borrowers had FICO credit scores above 700,[42] significantly higher than the minimum score of 620 which is usually required to receive a prime interest rate. The CEO of HSBC, which recently announced plans to purchase the US's largest subprime lender, Household International, said in a recent interview that 63% of Household's customer base (including consumers with car loans, credit cards, and unsecured loans) has prime credit.[43]

The most obvious consequence for borrowers who have been improperly steered into subprime loans is that they are unnecessarily paying more than they should. In the loans that were examined by the Department of Justice, the borrowers were paying interest rates of 11 and 12 percent and 10 to 15 points of the loan in fees, while borrowers with a prime loan had 7 percent interest rates and just 3 or 4 points of the loan in fees.

A trade group for subprime lenders, the National Home Equity Mortgage Association (NHEMA), stated that from 1997 to 1999, subprime loans had an average interest rate between 2.5% and 4.0% above the rate that prime borrowers are charged.[44] NHEMA also estimated that subprime lender charge an average of 1.5 to 3 percentage points more in fees than conventional lenders.[45] Many borrowers in subprime loans are, however, charged significantly more than these figures.

As discussed in this report, subprime loans are disproportionately made to lower income borrowers. This means that subprime lenders are overcharging those homeowners who can already least afford it. A subprime loan with inappropriately high costs can impact homeowners in several ways.

The added expense increases the likelihood that the homeowner will be unable to make the mortgage or other payments on time, which hurts their credit, and thus keeps them trapped in the subprime market with unfavorable loan terms. The higher costs also strip homeowners of their hard-earned equity and prevent

[39] Business Wire, "Fannie Mae has Played Critical Role in Expansion of Minority Homeownership Over Past Decade," March 2, 2000.
[40] *Inside B&C Lending*, June 10, 1996.
[41] "Automated Underwriting," Freddie Mac, September 1996.
[42] "Making Fair Lending a Reality in the New Millennium," Fannie Mae Foundation, 2000.
[43] "HSBC: Why the British Are Coming: Chairman John Bond explains why the usually cautious British bank paid a 30% premium to acquire American lender Household," *Business Week Online*, November 18, 2002, Daily Briefing.
[44] Jeffrey Zeltzer, Executive Director, National Home Equity Mortgage Association-NHEMA, remarks to HUD-Treasury Task Force on Predatory Lending, Atlanta, GA, April 26, 2000.
[45] "Widow paying a price for high-cost loan," *Orange County Register*, by Kate Berry, April 16, 2000.

them from building future equity. Furthermore, having a subprime loan means that the homeowner is more likely to be subject to a host of predatory practices, beyond just higher rates and fees, which will be discussed in more detail in the next section. All of these factors make it more likely that the homeowner will ultimately and unnecessarily lose their house in foreclosure.

PREDATORY LENDING PRACTICES

The reach and effect of abusive practices by predatory lenders have increased along with the dramatic growth of the subprime industry. The following are some of the more common predatory practices.

Financing Excessive Fees into Loans

Predatory lenders often finance huge fees into loans, stripping thousands of dollars in hard-earned equity and racking up additional interest in the future. Borrowers in predatory loans are routinely charged fees of just under 8% of the loan amount in fees, compared to the average 1%-2% assessed by banks to originate loans. Once the paperwork is signed and the rescission period expires, there is no way to get that equity back, and borrowers frequently lose up to $10,000 or $15,000 from their home while receiving little, if any, benefit from the refinancing. The damage is compounded at higher interest rates as borrowers often pay tremendous interest costs in the several years it can take just to pay down the fees. Typically, the loan fees are kept below 8% in order to stay under the HOEPA fee threshold established by federal law, which would then require additional disclosures to the borrower and a few very limited consumer protections.

A couple bought a house in need of substantial repairs for $2,500 from a previous owner who had fallen behind on his property taxes. To do some repairs, they took out a home-equity loan for $49,990, which was greatly inflated by 7.0 discounts points for $3,499, and $502 in third-party charges, as well as credit insurance policies totaling $4,992. Despite all the discount points paid, the loan's interest rate was 11.1%. After making all their payments for six months, the couple refinanced to a $78,247 mortgage to take out some additional equity. Again, the lender financed in 7.0 discount points – $5,477 – plus another $541 in third-party charges, while the interest rate increased to 11.9%.

Charging Higher Interest Rates Than A Borrower's Credit Warrants

While the higher interest rates charged by subprime lenders are intended to compensate lenders for taking a greater credit risk, too many borrowers are unnecessarily paying higher interest rates. Borrowers with perfect credit are regularly charged interest rates 3 to 6 points higher than the market rates; with some subprime lenders, there simply is no lower rate, no matter how good the credit. According to a rate sheet used by the Associates in the spring of 2000, their lowest interest rate for a borrower with excellent credit and a low loan-to-value ratio was over 10%, and since then Household borrowers with excellent credit were seeing rates above 11%. And for borrowers with imperfect credit, rates are frequently much higher than even somewhat blemished credit would reasonably warrant, as well as for what the industry describes as standard rates for B, C, or D borrowers.

A couple with children had bought a house with a variable interest rate mortgage that had stayed between 8% and 9%, and they had always been careful to make their payments on time. A few years later, they took out a second mortgage but subsequently were convinced that it would be easier to consolidate and make just one mortgage payment each month. The refinanced mortgage for $157,077 did not pay off all the debts that had been promised and included over $11,588 in the lender's financed fees. Despite all the discount points and their excellent credit record (the husband had a FICO score of 643, Empirica of 675, and Beacon of 700), the loan contained an interest rate of 10.8%. After talking with an ACORN Housing Corporation loan counselor, they were able to refinance the mortgage to a 6% interest rate, which will save them several hundred dollars a month but not restore any of their lost equity.

Making Loans Without Regard to the Borrower's Ability to Pay

Some predatory lenders make loans based solely on a homeowner's equity, even when it is obvious that the homeowner will not be able to afford their payments. Especially when there is significant equity in a home, the lender can turn a profit by reselling the house after foreclosure. Until that happens, the borrower is stuck with exorbitant monthly payments.

In other cases, the opportunity to strip away huge amounts of home equity drives the origination of clearly unaffordable mortgages. For mortgage brokers, the immediate opportunity to legally take away several thousand dollars of home equity more than offsets the eventual consequences of the loan, which will be dealt with by the holder on the secondary market. Similarly, personal commissions may push loan officers at mortgage companies to make loans that cannot be repaid.

A couple purchased their home through a special low-rate mortgage at 5% interest and monthly payments of $746. Shortly thereafter, they received an open-end second mortgage with a credit limit of $35,000, an initial advance of $36,800, an origination fee of $1,840, and a variable interest rate that started at 22.4%. The second mortgage's monthly payments of $742 were clearly unaffordable on the husband's monthly income as a janitor of $1,800 and the $546 they receive from SSI to help care for their hearing-impaired daughter. Without any other options, the couple was forced to sell their house and buy another less expensive one, but not before losing an additional $3,000 on a prepayment penalty.

Prepayment Penalties

More than two-thirds of subprime loans have prepayment penalties, compared to less than 2% of conventional prime loans.[46] The penalties come due when a borrower pays off their loan early, typically through refinancing or a sale of the house. The penalties remain in force for periods ranging from the first two to five years of the loan, and are often as much as six months interest on the loan. For a $100,000 loan at 11% interest, the penalty would be over $5,000, which would be financed into the new loan. For borrowers who refinance or sell their houses during the period covered by the prepayment penalty, the penalty functions as an additional and expensive fee on the loan, further robbing them of their equity.

Lenders argue that prepayment penalties protect them against frequent turnover of loans, and that as a result of the higher rates which investors are willing to pay for loans with prepayment penalties, they are able to charge borrowers lower interest rates. The truth is, however, that very large and quite predictable numbers of borrowers in subprime loans do refinance within the period covered by the prepayment penalty and may well end up paying more in the penalty than they "saved" even if their interest rate was reduced. It is particularly pernicious when prepayment penalties keep borrowers trapped in the all too common situation of paying interest rates higher than they should be.[47]

[46] HUD-Treasury Report on Predatory Lending, p. 90.
[47] See also the discussion below on how prepayment penalties interact with yield-spread premiums to trap borrowers in excessive interest rates.

Borrowers are frequently unaware that their loans contain a prepayment penalty. Some lenders' agents simply fail to point it out, while others deliberately mislead borrowers, telling them they can refinance later to a lower rate, without informing them of the prepayment penalty that will be charged. Even the most knowledgeable borrowers can easily the prepayment penalty amid the mounds of paperwork, and end up robbed of additional equity or trapped in an excessive rate because the penalty boosts up their loan-to-value ratio.

In a significant step forward in September, the federal Office of Thrift Supervision changed a rule interpretation that effectively restored a number of state laws providing varying levels of consumer protections against prepayment penalties. The state Attorneys General's settlement with Household also represents a major advance in requiring the country's largest subprime lender to limit all of its prepayment penalties to the loan's first two years, both retroactively and prospectively.

A homeowner got involved with a subprime lender and received a 16% interest rate despite having had excellent credit and having made all his payments on time. He was subsequently solicited by another subprime lender to refinance to a 7% interest rate, but the loan turned out much differently from what was promised. The new loan amount of $210,363 contained a financed origination fee of $15,251 and a single-premium credit life insurance policy for $5,113. Despite all the discount points, the interest rate was 11.2%, which he was locked into by a three-year prepayment penalty for $6,000. He tried to refinance with a prime lender, but the subprime lender refused to provide a payoff amount and then eventually quoted a penalty of $11,000 to the prime lender. At that point, the prime lender refused to refinance because the new loan would have exceeded the appraised value of the home.

Loans for Over 100% Loan to Value

Some lenders regularly make loans for considerably more than a borrower's home is worth with the specific intents of maximizing their debt and thus their payments, and trapping them as customers for an extended period. Even borrowers with excellent credit have no way to escape from a high rate loan if they are 'upside down' and owe more than their home is worth. Borrowers are frequently unaware that they owe much more than their homes are worth, and even more frequently unaware of the consequences. In the face of criticism from Wall Street and longstanding pressure from ACORN, in the spring of 2002 Household quietly eliminated its common practice of using extremely high-rate open-end second mortgages that push borrowers' LTV ratios above 100%.

A couple had bought their house with a 30-year mortgage for $137,000 at a 7.8% interest rate, and six months later they took out first a personal loan and then a second mortgage for $10,000 to buy some furniture. The lender kept soliciting them to increase their indebtedness and told them that they were two months behind on the second mortgage and could face foreclosure if they didn't consolidate their mortgages. The lender appraised their home for $165,000, which the couple thought would be the amount of their new loan, but the lender financed in its fees to raise the actual principal to $177,104, which was made at a 10.8% interest rate. Making it worse, the loan includes a three-year prepayment penalty for almost $10,000, and they found out they were only one month behind on the second mortgage. Despite the husband's middle credit score of 646, which is considered 'A' credit by many lenders, the couple now finds it impossible to refinance because the LTV ratio is over 100%.

Yield Spread Premiums

A yield spread premium is compensation paid by a lender to a mortgage broker for the broker's success in getting the borrower to accept a higher interest rate than the lender would have given the borrower at their standard, or "par," rate. Brokers usually receive this kickback on top of an already large origination fee financed into the borrower's loan. While brokers typically try to create the impression with borrowers that they are trying to secure the best possible loan, yield spread premiums create an obvious financial incentive for brokers to increase the loan costs. In the text of a proposed rule that would change how the premiums are disclosed but would not alter their fundamentally abusive nature, HUD estimates that lenders annually pay brokers $15 billion to increase borrower's interest rates – the same amount that borrowers pay in origination charges.[48]

Yield-spread premiums further harm borrowers in that the financial incentives often drive lenders to insist that the loans include prepayment penalties. Since by definition a yield-spread premium pushes the borrower into an excessive interest rate, borrowers who later realize their actual interest rate are more likely to refinance out of the loan. To reduce the likelihood that borrowers will refinance out and to ensure their profits even if they do, lenders often require brokers to also include a prepayment penalty when the interest rate is inflated due to a yield-spread premium.

A couple refinanced their mortgage through a broker, receiving a new balance of $109,200. Of this amount, $11,030 went toward various closing costs and fees, of which $5,138 went directly to the broker. On top of that amount, the lender paid the broker a yield-spread premium of $3,276 for putting the couple in a variable interest rate that starts at 12.3% and can go as high as 18.3%. In addition, the loan contains a two-year prepayment penalty for over $2,000 if they would try to refinance to a lower rate.

Home Improvement Scams

Some home improvement contractors deliberately target their marketing efforts to lower income neighborhoods where homes are in most need of repairs, and where the owners are unable to pay for the service. The contractor tells the homeowner they will arrange for the financing to pay for the work and refers the homeowner to a specific broker or lender, even driving them to the lender or broker's office. Sometimes the contractor begins the work before the loan is closed, so that even if the homeowner has second thoughts about taking the loan, they are forced into it in order to pay for the work. The lender may then make the payments directly to the contractor, which means that the homeowner has no control over the quality of the work. As a result, the work may not be done properly or even at all, but the homeowner is still stuck with a high-interest, high fee loan.

A homeowner hired a home improvement contractor to gut and rehab a large portion of her house. The contractor had a special arrangement with a mortgage company wherein the checks were made out directly to the contractor, rather than jointly to the borrower and the contractor. The contractor cashed checks totaling $52,000 but failed to perform the promised work, leaving the homeowner to pay off the 10% interest rate loan without having the work completed. After taking similar advantage of at least five other consumers, the contractor changed its name and relocated to a different address.

[48] Docket No. FR-4727-P-01, *Federal Register*, July 29, 2002, p. 49170.

Single Premium Credit Insurance

Credit insurance is insurance linked to a specific debt or loan which will pay off that particular debt if the borrower loses the ability to pay either because of sickness (credit health insurance), death (credit life insurance), or losing their job (credit unemployment insurance). It is rarely promoted in the 'A' lending world, but it has been aggressively and deceptively sold in 'single premium' form in connection with higher cost loans, and then financed into the home loans, costing borrowers equity in their homes, and forcing them to pay higher interest charges.

With 'single premium' policies, instead of making regular monthly, quarterly, or annual payments as people do with other insurance policies, the credit insurance is paid in one lump sum payment, which may be as high or even higher than $10,000, especially if borrowers are sold multiple forms of credit insurance, as is frequently the case. This premium is then financed into the loan, increasing the loan amount (and since the loan amount is higher, the lender's origination fees also increase), and the borrower must then pay monthly interest on the amount of the insurance premium. While the coverage on a single premium policy usually lasts for only 5 years, the borrower pays for it, and pays interest on it, over the 30 years of the home loan. After those 5 years and the coverage has expired, the remaining loan balance is usually higher than the original balance would have been minus the policy, meaning that the policy prevents the borrower from building up any equity. Typically, single premium credit insurance policies cost four to five times as much as monthly-paid credit insurance and over ten times as much as term life insurance policies, and of course the cost of these alternative products are not staked against the borrowers home.

Over the last couple years, a huge amount of attention to the damage inflicted by single-premium credit insurance has forced most major lenders to phase out the sale of this product. The HUD-Treasury report recommended the prohibition of such policies on all mortgages, Fannie Mae and Freddie Mac announced that they would refuse to purchase loans with financed credit insurance, and state laws enacted in North Carolina, California, Georgia, and New York have effectively prohibited the policies on all mortgages. At the end of last year, the Federal Reserve recognized that single-premium credit insurance policies function as an additional fee in counting the premiums toward the HOEPA points and fees threshold.

While all of these steps represent a huge breakthrough, unscrupulous lenders and brokers are shifting over to debt cancellation and suspension agreements, which technically do not provide insurance and can avoid some of the regulations but essentially function the same way. Other lenders are setting up the same incentive systems to reward loan officers' sales of monthly-paid credit insurance policies. While monthly-paid policies are not as damaging as the single-premium policies, such incentives push loan officers to slip in the policies without the borrower's consent, and borrowers frequently encounter the bureaucratic runaround when they try to cancel the policies.

A couple moved into their house with a 30-year mortgage at 6.8%. After encountering some financial problems, they responded to a solicitation and took out a second mortgage. When their car broke down a year later, they went back to the same lender, who told them they could only take out additional equity by refinancing their first mortgage. They agreed and the new first mortgage included single-premium credit life and disability insurance policies that increased their loan amount by $4,699 and $3,211, respectively. While the credit insurance and fees together comprised over 18% of their new principal, the loan's 15.0% interest rate meant that policies would have cost them tens of thousands more over the life of the loan. They are now trapped in the excessive rate as a result of having all their equity stripped away, and the husband suffered a heart attack from the stress caused by the loan and the extra hours he is having to put in at work.

Balloon Payments

Mortgages with balloon payments are arranged so that after making a certain number of regular payments (often five or seven years worth, sometimes 15), the borrower must pay off the remaining loan balance in its entirety, in one "balloon payment." About ten percent of subprime loans have balloon payments.[49]

There are specific circumstances where balloon payments make sense for some borrowers in loans at 'A' rates, but for most borrowers in subprime loans they are extremely harmful. Balloon mortgages, especially when combined with high interest rates, make it more difficult for borrowers to build equity in their home. After paying for some number of years on the loan, with the bulk of the payments going, as they do in the early years of a loan, to the interest, homeowners with balloon mortgages are forced to refinance in order to make the balloon payment. They incur the additional costs of points and fees on a new loan, and they must start all over again paying mostly interest on a new loan, with another extended period, usually thirty years, until their home is paid for.

In addition, many borrowers are unaware that their loan has a balloon payment, that their monthly payments are essentially only paying interest and not reducing their principal, and that the balloon will ultimately force them to refinance.

A senior citizen who lives on his Social Security income was convinced to take out a $14,450 second mortgage by a mortgage broker to help pay for his daughter's education. The broker promised that the loan would be paid off after five years of monthly payments of $209 and that he'd get a 10% interest rate, but when he got to closing it listed 13% (the broker received a yield-spread premium of $8,500). He didn't want to sign, but the broker told him he could refinance to a lower rate after a year. After making all his payments, he was shocked to learn that he faced a balloon payment for $14,000. When he called the lender in a panic, the lender told him there was no cause to worry and that he could easily refinance with them.

[49] HUD-Treasury Report on Predatory Lending, p. 92..

Negative Amortization

In a negatively amortized loan, the borrower's payment does not cover all of the interest due, much less any principal. The result is that despite regularly making the required monthly payment, the borrower's loan balance increases every month and they lose, rather than build, equity. Many borrowers are not aware that they have a negative amortization loan and don't find out until they call the lender to inquire why their loan balance keeps going up. Predatory lenders use negative amortization to sell the borrower on the low payment, without making it clear that this payment will cause the principal to rise rather than fall.

A woman took out a 10-year home-equity loan for $45,377 at an interest rate of 12.7%. She had taken out the loan because she thought that the monthly payments of $671 were affordable, not realizing that those payments would not cover the interest generated, let alone pay down any of the principal. She has made all of her payments for over a year, but her loan balance continues to rise.

Loan Flipping

Flipping is a practice in which a lender, often through high-pressure or deceptive sales tactics, encourages repeated refinancing by existing customers and tacks on thousands of dollars in additional fees or other charges each time. Some lenders will intentionally start borrowers with a loan at a higher interest rate, so that the lender can then refinance the loan to a slightly lower rate and charge additional fees to the borrower. This kind of multiple refinancing is never beneficial to the borrower and results in the further loss of equity. Flipping can also take place when competing lenders refinance the same borrowers repeatedly, promising benefits each time which are not delivered or which are outweighed by the additional costs of the loan.

A woman had bought her house over thirty years ago for $20,000. Now seventy-two years old, she has been targeted for repeated refinancings. In a five-year period, her loan was flipped seven times, with high financed fees and high rates each time. After one lender flipped her a third time, she was foreclosed on and lost her house.

Property Flipping

Property flipping is an elaborate scam in which unsuspecting first-time homebuyers are sold houses in serious states of disrepair for prices far above what the houses are actually worth.

The typical "property flip" begins with an investor or real estate company purchasing a distressed property for as little as a couple of thousand dollars. After doing minimal cosmetic or even no work to the property, the owner finds a buyer, frequently targeting low-income, minority families. The buyers have no agent representation of their own and no real estate knowledge, putting them at the mercy of the seller/owner. The seller/owner abuses this position by lying about the condition of the house, promising to make visibly-needed repairs, setting the sales price at far above the property's actual value, and referring the buyer to a subprime lender or broker.

Many subprime lenders will only make a purchase loan if the loan is for 80% or less of the value of the property. In these instances, the property seller uses a number of schemes in order for it to appear that the buyer has the required down payment of 20% or more. The seller first sets the sales price far above what the property is actually worth, then the seller falsifies the buyer's deposit and will often create a second mortgage, which exists on paper only. The key to the scam is having a lender or broker that will utilize appraisers who will support the property's inflated sales price. In exchange for their participation, the lender or broker is compensated by the fees and additional charges on the loan, which are often excessive.

Buying one's first house is often a major milestone in life and an important step towards achieving economic self-sufficiency, but the swindlers involved in property flipping have made the experience one of the worst things to ever happen to their victims. While there are no hard numbers about how many families have been victimized by property flipping, the problem reached epidemic proportions in many cities before the authorities were even aware that a problem existed. And although the economic downturn has played a role, HUD's failure to implement adequate reforms has contributed to the highest ever delinquency rates on FHA loans.[50]

A man bought his home for $120,000, but immediately realized that promised repairs had never been completed. When he removed some floorboards in the kitchen that had been severely damaged by termites, he realized that the kitchen floor was being held up by carjacks. The house also had enormous electrical wiring problems, damaged back doors, and a number of other problems. When the contractor refused to do the work, the man began putting aside $1,000 a month to do the repairs on his own. He kept making the mortgage payments, but then lost his job and without any financial cushion because of the extra repair costs he fell behind and eventually lost his home to a sheriff's sale.

Aggressive and Deceptive Marketing – The Use of Live Checks in the Mail

Much of the competition between lenders in the subprime industry is not based on the rates or terms offered by the different lenders, but on which lender can reach and "hook" the borrower first. Predatory lenders employ a sophisticated combination of "high tech" and "high touch" methods, using of multiple lists and detailed research to identify particularly susceptible borrowers (minority, low-income, and elderly homeowner) and then mailing, phoning, and even visiting the potential borrowers in their homes to encourage them to take out a loan.

One of the methods used routinely and successfully by predatory lenders is the practice of sending "live checks" in the mail to target homeowners. The checks are usually for several thousand dollars, and the cashing or depositing of the check means the borrower is entering into a loan agreement with the lender. The appeal of the checks is that are a fast and easy way for a homeowner to obtain cash.

This initial loan is just an entry point into the financial life of the homeowner. The loan has an artificially high interest rate and monthly payment, in order for the predatory lender to be able to offer the homeowner an opportunity to refinance it, along with other debts, into another loan at a slightly

[50] "2nd Quarter Foreclosure Rates Highest in 30 Years", *Washington Post*, by Sandra Fleishman, September 14, 2002, p. H1.

lower rate. The predatory lender's ultimate goal is to get the homeowner to refinance their entire mortgage with them.

A man bought his house with a 6.9% fixed interest rate mortgage for around $67,000 and monthly payments of $447. He has a serious heart condition, and a lender began sending him live checks in the mail. The first one he cashed resulted in an unsecured loan at an extremely high interest rate for $2,500, which he used to pay off medical and other bills as working became more difficult. After he cashed another check or two, the lender began soliciting him to take out a second mortgage. He ended up receiving an open-end line of credit with an initial advance of $26,000 on a credit limit of $25,000, which "reduced" his interest rate to 23.9%. The monthly payments are $580 – significantly higher than the first mortgage, which has about two and a half times as large a balance. The loan also included an origination fee of $1,300 and a five-year prepayment penalty for nearly $2,500.

RECOMMENDATIONS

For Legislators and Regulators

Congress should not preempt the ability of state legislatures and local officials to protect their constituents from predatory lending abuses. The measures enacted so far have not affected the prime market or restricted access to credit, while setting basic protections against some of the most common abuses that strip home equity, trap borrowers in excessive interest rates, and force families out of their homes.

Congress, state legislatures, and local officials should pass strong anti-predatory lending legislation that would protect consumers from abusive practices, which have been especially targeted at lower-income and minority communities. The legislation should follow the basic structure of S. 2438 – Senator Paul Sarbanes' bill in the 107th Congress[51] – in strengthening the protections provided in the federal Home Ownership Equity Protection Act (HOEPA), extending those protections to more borrowers in high-cost home loans, and establishing penalties for violating the law that are more in line with the damage caused to borrowers.

Federal banking regulators, in their evaluations of a bank's CRA performance, should give closer scrutiny to a bank's involvement in predatory lending. Regulators should consider not just the number of loans the bank originates to low-and moderate-income borrowers, but also the quality of those loans. In addition, banks that make high-cost loans directly or through their subsidiaries or purchase high-cost loans with predatory terms should be penalized under CRA for those activities, not rewarded.

Congress should increase the funding level for HUD's Housing Counseling Program well beyond the $20 million provided in FY 2002; it should be funded at least to the $40 million dollar level included in the Senate Appropriations Committee bill this year to increase the availability or housing counseling for potential predatory lending victims. To come closer to meeting the demand for such services, the annual funding level should be increased in future years to $100 million. Fannie Mae, Freddie Mac, mortgage lenders, and state and local governments should mandate and expand funding for programs that provide basic information about lending and enable people to protect themselves from predatory practices. The most effective tool for helping minority and lower-income families to become successful homeowners is high quality loan counseling and home buyer education by community based entities.

Federal and State regulators should increase their scrutiny of predatory lending practices, including examining the interest rates and other costs of loans as well as their distribution. Federal and state authorities should devote the necessary resources to investigating and prosecuting lending abuses.

The federal banking regulators must not worsen the problematic impact of credit scoring by penalizing lenders for making 'A' loans to any borrower with a credit score below 660. Unfortunately, the regulators are proposing higher capital requirements for lenders making such loans under a July 12 Federal Register notice regarding data collection on subprime loans made or

[51] Rep. John LaFalce introduced nearly identical legislation, HR 1051, in the 107th Congress.

purchased by banks and thrifts. Such a step could arbitrarily and unfairly exclude millions of consumers from the low rates and fees provided in the prime market, significantly raising the cost of homeownership for those families. In the final rule, the regulators also should follow the industry practice of classifying loans as subprime or not based on the rates and fees, not on the borrower's characteristics, and make public the data on subprime loan volume engaged in by banks and thrifts.

The Federal Reserve must follow through on collecting information on high-cost mortgages under HMDA, which is scheduled to begin in 2004. This will provide regulators, elected officials, and the public with the clearest picture to date on the concentration of high-cost mortgages in various communities and population groups.

For Lenders

All lenders that engage in subprime lending should pledge adherence to a meaningful "Code of Conduct" that includes: fair pricing; limits on financed fees and interest rates to those consistent with the actual credit risk represented by the borrower; avoidance of abusive and equity stripping loan terms and conditions, such as balloon payments, prepayment penalties, and single premium credit insurance; full and understandable disclosures of loan costs, terms, and conditions; a loan review system that rejects fraudulent or discriminatory loans; making no loans which clearly exceed a borrower's ability to repay; and not refinancing loans where there is no net benefit to the borrower. These lenders should review their loan portfolios and compensate borrowers whose loans clearly violate this code.

Lenders should quit sending in their high-priced lobbyists to try and stave off anti-predatory lending legislation. Prime lenders should especially be supportive of providing borrowers with protections on high-cost home loans, since they have a direct interest in discouraging unscrupulous lenders and brokers from refinancing borrowers out of prime loans into mortgages with much higher costs.

Lenders that offer prime as well as subprime products should establish uniform pricing and underwriting guidelines for all of their lending subsidiaries and for all of the communities in which they do business, so that consumers in lower-income and minority communities do not receive worse terms because of where they live or the color of their skin. All 'A' lenders should increase their outreach and loan volume in underserved communities for their prime loan products.

Lenders should fund nonprofit housing counseling agencies to work with low and moderate income borrowers in the subprime market. Consumers need correct information to make informed loan decisions in the complex and often misleading subprime market transactions. Housing counselors are able to review income, credit, debts, and loan products to help the borrower find the best loan product for their needs and avoid predatory loan terms. Housing counseling agencies that provide one-on-one and classroom counseling have been found to reduce ninety-day delinquency rates by 34 percent and 26 percent, respectively.[52]

[52] "Prepurchase Homeownership Counseling: A Little Knowledge is a Good Thing," by Abdighani Hirad and Peter Zorn, in *Low-Income Homeownership: Examining the Unexamined Goal*, ed. Nicolas Retsinas and Eric Belsky, 2002, p. 147.

For Consumers

To Protect Yourself From Predatory Lenders

Before you begin loan shopping, visit your local non-profit housing counseling center to set up an appointment with a counselor to evaluate your financial situation and to discuss your loan needs. ACORN Housing Corporation, a HUD-certified housing counseling agency, has offices in 29 cities, which are listed at www.acornhousing.org. You can also call HUD toll-free at 1-800-569-4287 for a list of the certified counseling agencies nearest you.

You can and should also talk with a housing counselor to evaluate the loan offers you are receiving if you are already in the middle of the loan process. Many of the borrowers who receive high cost loans could have qualified for a lower cost loan from a bank.

Ignore high-pressure solicitations, including home visit offers. Before you sign anything, take the time to have an expert – such as a housing counselor or lawyer – look over any purchase agreement, loan offer from a lender or broker, or any other documents.

Don't agree to or sign anything that doesn't seem right, even if the seller or lender tells you that "it's the only way to get the loan through" or "that's the way it's done." Look over everything you sign to make sure all your information is correct, including your income, debts, and credit. Do not sign blank loan documents or documents with blank spaces "to be filled out later."

Before closing your loan, get a copy of your loan papers with the final loan terms and conditions so you have enough time to examine them. If anything is dramatically different at closing, don't sign it.

Don't accept a lender's statement that you have bad credit without reviewing your credit report yourself for mistakes and inaccuracies and having an independent person evaluate your credit report.

Make sure you are comparing apples to apples. Know exactly what debts will and will not be paid and if your new payment will include taxes and insurance. You should also understand if the payment being quoted is sufficient to pay off the loan or only goes toward the interest.

Be wary of any lender or broker who encourages you to refinance your first mortgage if that's not what you are looking to do or if they encourage you to add more and more of your other debts into the loan.

Think twice about borrowing more than the value of your house. Some lenders may make loans for more than your house is worth, up to a 125% loan to value. Owing more than your house is worth can prevent you from selling your house or refinancing to a better rate in the future.

Beware of loan terms and conditions that may mean higher costs for you:

• High points and fees: Bank loans usually cost 1-3% of the loan amount for points and fees to the lender. If you are being charged more, find out why. Then shop around.

• Single premium credit insurance or debt cancellation agreements: This kind of insurance is very expensive compared to other insurance policies, and paying it up front requires you to pay interest on it as well. Beware.

• Prepayment Penalty: Many subprime loans include prepayment penalties, which require you to pay thousands of dollars extra if you sell the house or refinance your loan within the first several years of the loan. Make sure you know if the loan you are being offered has a prepayment penalty, how long it is in effect, and how much it will cost. If there is a chance that you will refinance or sell your home during that time, you need a loan without a prepayment penalty.

• Balloon Payments: Balloon mortgages have the payments structured so that after making all your monthly payments for several years, you still have to make one big "balloon payment" that is almost as much as your original loan amount.

• Adjustable Rates: Beware of low "teaser" introductory rates on adjustable mortgages because many of these adjustable rate loans only adjust one way – up. If your loan has a fixed initial rate, make sure you know when and by how much the interest rate will increase and what your new monthly payments will be. Find out the highest rate your can go to and what the monthly payments would be at that rate. Don't count on a promise that the lender will refinance the loan before your payments increase.

• Mandatory Arbitration: Some predatory lenders include mandatory arbitration clauses in their home loans. Signing these can mean giving up your right to sue in court if the lender does something that is illegal.

Be Careful with Debt Consolidation Loans. If you are thinking of a debt consolidation loan, be aware that although it may lower your monthly payments in the short term, you may end up paying more in total over time. Also, there is an important difference between most of your bills – such as for credit cards – and mortgage debt. When you consolidate other bills with your mortgage, you increase the risk of losing your home if you can't make the payment.

Watch Out for Property Flipping Scams When Buying a Home. A property flipper buys a house cheap and then sells it to an unsuspecting homebuyer for a price that far exceeds its real value. Too often, the buyer finds out after closing that the home needs major repairs they can't afford and they lose the house in foreclosure.

- Have an independent home inspector make sure the house is in good condition. This should be in addition to the appraisal that the bank orders. While an appraisal estimates the value of your home, a good home inspection will identify needed repairs. Do your own homework to find a good inspector – an inspector recommended by the seller may not be working in your interest.

- Make sure you have your own Realtor or real estate agent who is working for you. Never deal directly with a seller or a seller's agent unless you have extensive real estate experience. Having your own Realtor will not cost you anything more because they are paid out of the sales price of the house.

- If the seller agreed to make repairs to the home, conduct a final walk-through to make sure the repairs have been completed before the loan closing.

Look Out for Home Improvement Scams. Some home improvement contractors work together with lenders and brokers to take advantage of homeowners who need to make repairs on their homes. They get the homeowner to take out a high-interest, high-fee loan to pay for the work, and then the lender pays the contractor directly. Too often, the work is not done properly or even at all.

- Get several bids from different home improvement contractors. Don't get talked into borrowing more money than you need.

- Check with the state Attorney General's office to see if they have received any complaints about the contractor.

- Don't let a contractor refer you to a specific lender to pay for the work. Shop around with different lenders in order to make sure that you are getting the best possible loan.

- Make sure any check written for home improvements is not written directly to the contractor. It should be in your name only or written to both you and the contractor, and you should not sign over the money until you are satisfied with the work they have completed.

If you feel that you have been discriminated against or are a victim of predatory lending call ACORN at 1-877-692-0233 or e-mail us at acorndcadmin@acorn.org to become part of our campaign against predatory lending.

METHODOLOGY

This report analyzes data released by the Federal Financial Institutions Examination Council (FFIEC) about the lending activity of more than 7,600 institutions covered by the Home Mortgage Disclosure Act (HMDA). HMDA requires depository institutions with more than $32 million in assets as well as mortgage companies which make substantial numbers of home loans to report data annually to one of the member agencies of the FFIEC--the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision--and to the Department of Housing and Urban Development (HUD). The reporting includes the number and type of loans correlated by the race, gender, income, and census tract of the applicants, and the disposition of those applications, in each Metropolitan Statistical Area (MSA) where loans are originated.

HMDA data does not distinguish between prime and subprime loans. In order to analyze the subprime market, we used the list of subprime lenders developed by HUD, and considered loans made by lenders on that list as subprime loans. HUD also maintains a list of manufactured housing lenders, and we considered loans made by these lenders as manufactured housing loans. Loans made by lenders that were not on either list were considered as prime loans. HMDA data does distinguish between government insured and conventional loans. We considered only conventional home purchase and conventional refinance loans in this report.

We are grateful for the work of Randall M. Scheessele with the U.S. Department of Housing and Urban Development whose research was used to measure the growth of subprime lending.

The report examines figures for the nation as a whole, as well as for sixty-seven individual metropolitan areas: Little Rock, AR; Pine Bluff, AR; Phoenix-Mesa, AZ; Tucson, AZ; Fresno, CA; Los Angeles-Long Beach, CA; Oakland, CA; Orange County, CA; Riverside-San Bernardino, CA; Sacramento, CA; San Diego, CA; San Francisco, CA; San Jose; CA; Stockton-Lodi, CA; Denver, CO; Bridgeport, CT; Hartford, CT, New Haven, CT; Stamford-Norwalk, CT; Waterbury, CT; Wilmington, DE; Washington, DC; Ft. Lauderdale, FL; Jacksonville, FL; Miami, FL; Orlando, FL; Tampa-St. Petersburg, FL: Atlanta, GA; Chicago, IL; Ft. Wayne, IN: Gary, IN; Indianapolis, IN; Baton Rouge, LA; Houma, LA; Lake Charles, LA; New Orleans, LA; Boston, MA; Brockton, MA; Springfield, MA; Baltimore, MD; Detroit, MI; Minneapolis-St. Paul, MN; Kansas City, MO; St. Louis, MO; Bergen-Passaic, NJ; Jersey City, NJ; Newark, NJ; Albuquerque, NM; Las Cruces, NM; New York City, NY; Nassau-Suffolk, NY; Cincinnati, OH; Cleveland, OH; Columbus, OH; Toledo, OH; Portland, OR; Philadelphia, PA; Pittsburgh, PA; Providence, RI; Sioux Falls, SD; Memphis, TN; Dallas, TX; Fort Worth-Arlington, TX; Houston, TX; San Antonio, TX; Seattle, WA; and Milwaukee, WI.

In making lists of those metropolitan areas with the most and least concentrated lending, and with regard to other similar characteristics, we have excluded those metropolitan areas which had fewer than 50 loans originated to the group in question.

TESTIMONY SUBMITTED BY THE:

CONSUMER MORTGAGE COALITION

COMMITTEE ON FINANCIAL SERVICES

SUBCOMMITTEES ON HOUSING AND FINANCIAL INSTITUTIONS

"Efforts to Prevent Abusive Mortgage Lending"

November 5, 2003

The Consumer Mortgage Coalition ("CMC"), a trade association of national residential mortgage lenders, servicers, and service providers appreciates the opportunity to submit its written testimony concerning predatory mortgage lending to the House Financial Services Subcommittees on Housing and Financial Institutions.

In considering the problem and impact of, and possible responses to, "predatory lending," we emphasize the following key points:

- ***Many abusive practices are the result of outright fraud.*** As we examine the anecdotal descriptions of borrowers being abused, it is clear that many of the abuses resulted from misrepresentation, deception and other practices that violate existing laws. New laws are not needed to address these problems. Rather, there must be a renewed emphasis on devoting the necessary resources to enforce existing law.

- ***"Predatory lending" is hard to define.*** Practices (other than those constituting current illegal conduct) that are often labeled "predatory" can have both adverse and beneficial consequences for consumers. As policy makers consider restricting individual terms and provisions, such as prepayment penalties and yield spread premiums, they must understand that these terms have legitimate uses that can benefit consumers, for example, by reducing interest rates or upfront costs.

- ***It is not in the interests of lenders and servicers to make loans, whether prime or subprime, which result in default or foreclosure.*** Lenders and services do not benefit from defaulted loans. Rather they lose money—often significant amounts. Simply put, a lender whose loans that go into default represent more than a small proportion of its total loans will not long be in the lending business. In fact, because subprime borrowers by definition present a greater risk, subprime lenders must devote additional resources to ensuring that they will not end up with a defaulted loan.

- ***The goal of policymakers in addressing "predatory lending" should be to educate and empower consumers to make appropriate decisions about their financial affairs, not to restrict consumers' option.*** The CMC is convinced that both consumers and lenders are better off if lenders have the freedom to offer and consumers have the freedom to choose from the widest range of financial options. Consumers, however, must be put in a position to make an informed decision that is most appropriate for their needs and situation.

- ***Current regulatory requirements do not allow consumers to understand their choices. They often act as barriers to competition that could reduce costs.*** Studies have shown that the innumerable disclosures required by a variety of federal and state laws often confuse, and sometimes mislead, consumers who are attempting to shop for loans. In addition, while lenders compete on their offerings based on interest rate and points, because of regulatory restrictions, there is little incentive to compete on the basis of ancillary settlement costs.

The CMC developed a five-part program that we believe best addresses "predatory lending" without unduly restricting consumer's options or unduly burdening the efficient operation of the mortgage market. The program consists of the following:

- ***Adequate enforcement of existing law***
- ***A nationwide licensing registry that allows constant monitoring by state regulators and consumers of licensing complaints, suspensions and revocations***
- ***A comprehensive public awareness and education campaign***
- ***Implementation of Federal regulators' existing authority to address predatory practices***
- ***Reform of mortgage origination regulatory requirements to give consumers simpler, more uniform disclosures that allow them to understand and effectively comparison shop for loans, to give lenders the ability to offer ancillary settlement services at lower cost, and to provide certain substantive protections.***

Following a brief note describing our coalition, we examine each component of this comprehensive solution. In addition, in Tab 1 of this testimony, we describe the subprime market. In Tab 2, we describe the products and practices that often are labeled "predatory," and show how they can be used to the benefit of borrowers and how our solutions would mitigate any abuses they could cause. Finally, in Tab 3, we describe the mortgage origination process, its participants and the compensation each receives for their role.

About the CMC

The CMC was formed, in large part, to pursue reform of the mortgage origination process. From our perspective, one of the principal goals of mortgage reform is to streamline the mortgage origination process so that consumers would be better informed when making credit choices. Complementary to our goal of streamlining the mortgage origination process is the goal of reducing abusive lending practices. We believe that better disclosures and substantive protections can enhance consumer protection. The goal should be to allow consumers to make educated choices in the credit market.

We commend the Committee for its continued attention to the issue of predatory lending. The CMC is particularly concerned because of the damage caused by deceptive lenders to consumers and to the image of our industry. We support the goal of protecting consumers from unscrupulous lending practices and recognize that some elderly and other vulnerable consumers have been subjected to abuses by a small number of mortgage lenders, brokers and home contractors. We share the Committee's objective of developing approaches that prevent predatory lending practices without restricting the supply of credit to consumers or unduly burdening the mortgage lending industry.

The CMC's Alternative: A Comprehensive Solution to Predatory Lending

Rather than further restrictions on products, terms and provisions, the CMC favors a multi-tiered, comprehensive solution to predatory lending, including increased enforcement of existing prohibitions against fraud and deception, coordinated, nationwide enforcement of licensing requirements, and better consumer education on the mortgage process.

Most significantly, the CMC believes that comprehensive reform of the regulation of the mortgage origination process is needed so that all consumers, but particularly those most vulnerable to predatory lending practices, can better protect themselves. As noted above, our solution has five parts.

Part 1: Devoting Adequate Resources To Enforcing Existing Laws

We agree with Federal Reserve Board Chairman Alan Greenspan's comments that enforcement of existing laws is the first step that should be taken. Many examples of predatory lending involve fraudulent practices that are clearly illegal under current law. Adequate resources at both the federal and state levels of government need to be devoted to pursuing those committing fraud. Therefore, the appropriate federal and state agencies should advise policymakers of the resources they need to combat mortgage fraud.

Part II: A Nationwide Licensing Registry

We recommend that all mortgage brokers and companies be licensed, and that a federal system be established to ensure that if a broker or company loses its license in one state as a result of predatory practices, all licenses would be revoked, suspended, or put on regulatory alert nationally. A "Consumer Mortgage Protection Board" could be established to maintain a clearinghouse to identify mortgage brokers and companies whose licenses have been revoked or suspended in any state.

The goal of this recommendation is to prevent those engaging in predatory practices from being able to move from one jurisdiction to the next and continuing to prey upon vulnerable consumers while keeping one-step ahead of law enforcement authorities in prior jurisdictions.

This new Consumer Mortgage Protection Board could also be responsible for, among other things, reviewing all new and existing Federal regulations and procedures relating to the mortgage origination process and make recommendations that will simplify and streamline the lending process and make the costs of the process more understandable to consumers. The Board could also be used to initiate and oversee public awareness media programs (described below) that will help consumers evaluate the terms of loan products they are considering.

Part III: Increasing Public Awareness and Improving Consumer Education

Consumer advocates have long advised industry and government officials that certain consumers, particularly elderly seniors, were not able to clearly understand the loan terms disclosed in the innumerable disclosures provided to consumers during the mortgage process.

We recommend a three-step program to increase public awareness and improve consumer understanding of their loan obligation:

1. *Public Service Campaign*.

   Federal policymakers should implement an ongoing, nationwide public service campaign to advise consumers, but particularly the more vulnerable such as senior citizens and the poorly educated, that they should seek the advice of an independent third party before signing any loan agreements. Public service announcements could be made on radio and television, and articles and notices could be run in local newspapers and selected publications.

2. *Public Awareness Infrastructure.*

   Once alerted, consumers will need to be able to avail themselves of counseling services from unbiased sources. Those sources can always include family and friends and industry participants. In addition, however, a nationwide network should be put in place to ensure that all consumers can easily access advice and counseling to help them determine the loan product that best fits their financial needs. A public awareness infrastructure could be built out that would include 1-800 numbers with independent counselors, using sophisticated computer software, to help consumers talk through the loan product they are considering. In addition, programs could be developed with community organizations and other organizations serving senior citizens to provide on-site counseling assistance at local senior and community centers and churches. HUD's 800 number for counseling could be listed on required mortgage disclosures as an initial step to increase awareness of available advice.

3. *"Good Housekeeping Seal of Approval" for On-Line Mortgage Calculators*

   The *Joint Report on the Real Estate Settlement Procedures Act and Truth in Lending Act* of the Board of Governors of the Federal Reserve System and the Department of Housing and Urban Development, issued in 1998 ("Joint Fed/HUD Report") recommended that the government develop "smart" computer programs to help consumers determine the loan product that best meets their individual needs. Since this idea was first discussed in the Mortgage Reform Working Group,[1] mortgage calculators or "smart" computer

[1] The Mortgage Reform Working Group ("MRWG") was an ad-hoc group, comprised of over 20 trade associations and consumer advocate organizations, that was organized at the request of former Congressman Rick Lazio (R-NY) with the goal of reaching a compromise on a comprehensive mortgage reform proposal that would streamline and simplify the mortgage process for consumers while simultaneously reducing the liability for the industry. While all parties did not reach an agreement, many of the recommendations that were developed in that process formed the basis for the recommendations made in the Joint Report issued by the Federal Reserve Board and the Department of Housing and Urban Development.

programs have become available online. Since these computer programs were already developed by the private sector and are widely available, a more appropriate role for the government today would be for the federal government to approve a limited and unbiased generic mortgage calculator module that could be incorporated into any online site that helps consumers evaluate various loan products. (Legislation may be needed to advance this initiative. But there may be resources in agencies' current budgets that could be tapped to implement this recommendation.)

Part IV: Use Existing Federal Regulatory Authority to Stop Abusive Practices

Regulators may have existing authority to implement changes to existing regulations to prevent loan flipping and other questionable practices. Where such authority exists, action should be taken to change existing regulations. Regulators may also be able to use their rulemaking powers under existing law to implement some of the mortgage reform proposals discussed in Part V.

Part V: Comprehensive Mortgage Reform

There is widespread agreement that the mortgage loan origination process is overly complex and that the current legal structure is often an obstacle to improving that process.

Comprehensive mortgage reform would reduce confusion and improve competition, lowering prices for all consumers while discouraging predatory lending. The CMC has been at the forefront of industry efforts to reform and improve the laws and regulations governing the home mortgage origination process in this country. The mortgage reform that we, along with others in the industry, have advocated would directly address many of the weaknesses in current law that allow predatory lenders to operate. We note that some of these reforms can be achieved through regulatory changes while others will require legislation.

Some of the features of mortgage reform that bear directly on the predatory lending problem include:

- ***Early Disclosure of Firm Closing Costs***, leading to greater certainty for consumers on closing costs and increased price competition for both loans and ancillary services required to make the loan. A common feature of most allegations of predatory lending is that the borrower was either confused or deliberately misled about the amount of closing costs that he or she would have to pay. The central feature of mortgage reform is a proposal that mortgage originators disclose to consumers the firm, not estimated, costs of the ancillary services needed to make the loan for which the consumer has applied. If the borrower receives a clear disclosure of firm closing costs early in the transaction, it will be more difficult for an abusive lender or broker to misrepresent the terms of the loan and the borrower will have time to seek financing from other sources if the terms are unfavorable.

Offering guaranteed closing cost packages will not work without a corresponding exemption from Section 8 of RESPA for arrangements negotiated between the lender or mortgage broker and the providers of ancillary services whose costs are included in the firm closing costs disclosure. Thus, for example, lenders would be free to negotiate volume discounts or other pricing arrangements with their service providers without the restrictions of Section 8. If a lender or broker charged more than the total listed on the firm closing costs disclosure, other than those few items, such as taxes and per diem interest, which are not included in the disclosure, it would risk losing its Section 8 exemption. Under current law, the constraints imposed by Section 8 give lenders little incentive to reduce third-party closing costs.

- ***Simplified, Understandable Disclosures*** of key information about the loan. Mortgage reform would consolidate and highlight disclosures of the key terms of a mortgage credit product so that applicants could easily comparison-shop for loans. It would eliminate confusing disclosures such as the "Amount Financed," which has actually been used to mislead consumers about the true amount of the obligation. The disclosure of firm closing costs, noted above, would include any mortgage broker fee paid by the borrower.

- ***Proportional Remedies*** so that lenders are the targets of less litigation over harmless or minor errors while consumers can be compensated for actual harms. The remedies in the mortgage reform proposal, in contrast to current law, are structured to ensure that the borrower receives a loan on the terms that were disclosed. Lenders that detect and correct errors quickly will not be penalized, while those that engage in knowing and willful violations will be penalized more severely than under current law.

- ***Substantive Protections against Loan Flipping*** to protect the most vulnerable consumers from abusive loans. The focus of the mortgage reform effort is on reforming the mortgage process for all consumers, but we include an enhancement to the Home Ownership and Equity Protection Act ("HOEPA") in the form of protections against loan flipping. Under the proposal, when making a HOEPA loan that refinances an existing mortgage loan and that is entered into within twelve months of the closing of that loan, the originator may not finance points or fees payable to the originator or broker that are required to close the loan in an amount that exceeds three percent of the loan amount. This limitation does not apply to voluntary items such as credit insurance, nor to taxes and typical closing costs for settlement services such as appraisal, credit report, title, flood, property insurance, attorney, document preparation, and notary and closing services provided by a third party, whether or not an affiliate.

  Limiting the financing of points will mean that borrowers would have to bring cash to closing to pay high points and fees. This will mean that borrowers of HOEPA loans will be less likely to be "flipped" numerous times. Consistent with regulations adopted by the New York State Banking Department, the limit on refinancing points does not apply to typical third-party closing costs.

Significantly, this restriction is not limited to refinances by the same lender and would thus apply to a much broader number of loans that may not be in the category of "flipped" loans. For this reason, it is appropriate that a reasonable amount of points and fees be eligible to be financed in order to meet real credit needs.

- ***Substantive Protections Affecting Prepayment Penalties.*** On non-HOEPA loans, no prepayment penalty would be permitted after 5 years from the date of the loan. However, prepayment penalties would be authorized during this 5-year period, notwithstanding state law. Any prepayment penalty permitted would be limited to a maximum of 6 months' interest on the original principal balance.

- ***Foreclosure Reforms*** to provide additional protections to borrowers facing the loss of their home without reducing the value of lender's security interest in the property. Lenders and servicers have in recent years significantly changed their procedures for dealing with delinquent borrowers. Workouts, forbearance and other loss mitigation tools are employed and foreclosure is increasingly seen as an expensive (for everyone) last resort. In addition to this business trend, we would support the enactment of a new "Homeowner's Equity Recovery Act" ("HERA"), which would apply at the time lender notifies consumer of consumer's default and rights under HERA.

    - HERA protections would apply if the consumer's indebtedness (origination balance and interest, junior liens, etc.) is not more than 80% of the origination valuation. A consumer would have the right to list the property with a real estate broker or otherwise make a good faith effort to sell the property.

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We believe that the consumer protections made available through HERA strike a reasonable balance between the rights of lenders and investors for repayment of amounts owed and the consumer's right to "breathing room" if the consumer is attempting to resolve the default. However, we do not support the expansion of mandatory judicial foreclosure because it is costly both to the consumer and lender, and is too time consuming, which, among other things, puts the collateral at risk. In addition, we note that the Federal tax code (REMIC provisions), under which loans are sold to the secondary market, places limitations on types of compromise that a lender can offer to a defaulting borrower.

- ***Substantive Protections Affecting Collection Practices.*** Under the proposal, the prohibitions contained in Section 806 of the Fair Debt Collection Practices Act ("FDCPA") concerning harassment and abuse would be extended to the collection of mortgage loan debts by a creditor or its affiliates. The law would be clarified to ensure that loan servicers that collect debts as part of their servicing function would not be treated as debt collectors

- ***Uniform, National Rules*** so that lenders can comply with a uniform set of disclosure requirements that will adequately protect consumers and result in lower costs to lenders and lower rates for borrowers. Imposing uniform laws and regulations ensures that consumers – across the nation – are afforded the same protections. Uniform, national rules would also reduce the number of documents to be signed by consumers at closing. "Information overload" is an almost universal feature of complaints about predatory lending.

  Uniform, national rules are particularly important because the need for uniformity has never been greater. There has recently been a proliferation of state and local legislation to combat predatory lending practices. Although well intentioned, these initiatives can be counterproductive because they can impose very high costs on lenders in comparison to the potential number of loans affected.

  In one example, Georgia enacted anti-predatory-lending legislation that was so broad in its sweep that it threatened to cut off legitimate, mainstream lending as well as the practices at which it was targeted. Corrective legislative action was enacted to prevent the originally passed legislation from shutting down legitimate mortgage lending in the State of Georgia.

  If the Committee decides that clarification of the existing legislation prohibiting abusive practices is needed, we strongly urge that it create a single, nationwide standard that cannot be undermined by myriad local initiatives.

* * *

The CMC appreciates the opportunity to submit its views on the problem of, and appropriate responses to, "predatory lending." We look forward to working with the Subcommittees on constructive, practical solutions to address abuse practices without restricting the availability of credit, reducing consumers' options, or burdening the efficient operation of the mortgage market.

DESCRIPTION OF SUBPRIME MARKET

Although the involvement of CMC's members in subprime lending varies, all CMC members share an interest in the efficient operation of the mortgage lending market. Subprime lending plays a crucial part in that market, allowing individuals who do not qualify for "prime" loans to make use of the equity in their homes to obtain credit at reasonable rates. As Comptroller of the Currency John D. Hawke, Jr., noted in a letter to the Senate Banking Committee—

> "One problem with the fact that 'predatory lending' is not susceptible to precise definition is that many people make the mistake of equating subprime lending to predatory lending. Responsible, risk-based subprime lending, that provides access to credit for individuals with less than perfect credit histories, should not, in and of itself, be considered predatory. The OCC encourages national banks to engage in responsible subprime lending, and has issued guidance to ensure that banks engaging in this type of business do so in a safe and sound manner and consistent with applicable consumer protection law."[2]

Legitimate subprime lending offers many benefits to consumers. A subprime home loan provides financial options to borrowers who cannot obtain prime loans because of problems with their credit history or for other reasons such as a reduction in income or other change in financial circumstances. Subprime credit gives such individuals a chance to buy a home. In other instances, the availability of subprime home-equity credit gives credit-impaired borrowers financial options that would not otherwise be available, including debt consolidation or other purposes.

The Subprime Mortgage Industry

Mortgages are the largest component of the U.S. debt market with over $5 trillion in outstandings. Total first mortgage origination volume in 2000 was over $1 trillion. Subprime mortgage lending accounted for approximately 13% of the entire mortgage industry's production in 2000.

Scale, capital and risk management requirements are driving rapid consolidation in the mortgage banking and servicing sectors of the industry. However, the mortgage origination business remains relatively fragmented.

[2] Letter from John D. Hawke, Jr., Comptroller of the Currency, to the Honorable Phil Gramm, Chairman, Committee on Banking, Housing, and Urban Affairs, United States Senate, May 5, 2000.

Subprime Credit Borrowers and the Use of Subprime Credit

Subprime borrowers are like any other borrowers in the U.S. economy. In fact, a study of nearly one million subprime and manufactured housing loans originated in 1998 shows a racial and ethnic borrower profile similar to the racial and ethnic composition of the total U.S. population.[3]

As practiced by mainstream lenders, including those CMC members who participate in the subprime market, subprime lending is also not conceptually different from lending to "prime" borrowers. The process begins when the borrower identifies a need for financing, either for a home purchase or for cash for other purposes. Although a significant portion of subprime loans are made to finance the purchase of a home, the proportion is lower than for prime loans.[4]

More frequently, a subprime borrower will seek cash to consolidate existing debt—the most common use of subprime credit. Home equity financing often allows the borrower to reduce monthly payments dramatically, allowing an overextended consumer to gain control of his or her budget. In addition, subprime loans carry significantly lower interest rates than other forms of credit. Although subprime loans average about 250 basis points (2.5 percentage points) above prime loans, at around 9.5%-10% they are still much less expensive than credit cards and other sources of credit (when those alternative sources are even available to credit-impaired borrowers).

Other common uses of subprime home equity loans include—

- Financing a college education;
- Paying medical bills;
- Providing alternatives for homeowners who fall behind on their mortgage payments; and
- Home improvement and repair.

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[3] An April 2000 SMR Research study of 1998 HMDA data.

[4] An April 2000 SMR Research study of 1998 HMDA data showed the following distribution of loans by loan purpose:

Purchase	Refinancing	Home Improvement	Total
Subprime loans			
197,917	661,876	94,116	953,909
20.75%	69.39%	9.87%	100.00%
Prime loans			
3,968,766	5,863,187	819,393	10,651,346
37.26%	55.05%	7.69%	100.00%

Subprime Credit Grades

In the mortgage industry, loans are graded from "A" (a prime loan) to "D" (the riskiest subprime loan). An "A" loan is a "prime" loan, or a loan of the highest credit value. Typical factors that determine a consumers credit grade are:

- Mortgage delinquency history
- Consumer debt delinquency history
- Bankruptcy or foreclosure
- Collection or judgments
- High debt-to-income ratios
- High loan-to-value ratios
- Low credit risk scores

Although the definitions of the subprime grades are neither precise nor completely uniform throughout the industry, the following examples convey the general concept of credit grading:

- A homeowner who filed for bankruptcy two years ago due to mismanagement of credit and was sixty days late on his current mortgage may qualify for a "B-" credit grade;

- A borrower who was laid off and had to accept a lower-paying job, and, as a result, was occasionally thirty days late in making her mortgage payment may qualify for an "A-" credit grade; and

- A widow who has an excellent credit record but has had difficulty in paying outstanding medical and home repair expenses and needs cash for her son's college education may qualify for a "B" credit grade. In this example, the subprime credit grade is based on income compared to total amount of debt, rather than on credit history.

SPECIFIC PRACTICES OFTEN LABELED "PREDATORY"

In this section we discuss a number of practices that have been attacked as "predatory."[5] As the Board of Governors of the Federal Reserve System has noted, there are two types of abusive practices in home equity lending—blatant fraud or deception, and the use of practices that are not inherently abusive but can be misused to injure consumers:

> "[A]busive practices in home-equity lending take many forms but principally fall within two categories. One category includes the use of *blatantly fraudulent or deceptive techniques* that may also involve other unlawful acts, including violations of HOEPA [the Home Ownership and Equity Protection Act]. These practices occur even though they are illegal. For example, loan applicants' incomes and ability to make scheduled loan payments may be falsified, consumers' signatures may be forged or obtained on blank documents, or borrowers may be charged fees that are not tied to any service rendered. The other category of abuses involves various techniques used to manipulate borrowers, *coupled with practices that may ordinarily be acceptable but can be used or combined in abusive ways*. . . . [S]ome loan terms that work well for some borrowers in some circumstances may harm borrowers who are not fully aware of the consequences. For example, a consumer may not understand that a loan with affordable monthly payments will not amortize the principal or that the consumer may have to refinance a balloon payment at additional cost."[6]

Fraud and Deception

Predatory lenders who are disregarding existing legal requirements—including, in many cases, prohibitions against fraud and forgery that predate current consumer protections by many centuries—will not be deterred by additional rules. Instead, public policy should focus on more effective and sophisticated enforcement of those existing requirements. Examples of "predatory" practices that are prohibited under current law include the following:

Misleading Solicitations

Advertising and marketing material may mislead consumers about the true cost or nature of a loan. These marketing practices are already prohibited under the Federal

[5] This list of alleged predatory lending practices is largely drawn from Patricia Sturdevant and William J. Brennan, Jr., *The Double Dirty Dozen Predatory Mortgage Lending Practices* (National Association of Consumer Advocates, Inc. 2000).

[6] Testimony of Gov. Edward M. Gramlich before the Committee on Banking and Financial Services, U.S. House of Representatives (May 24, 2000) (emphasis added).

Trade Commission Act and analogous state laws. In many instances, deceptive solicitations also violate the Truth in Lending Act.

Home Improvement Scams

A home improvement contractor may originate a mortgage loan to finance the home improvements and sell the loan to a lender, or steer the homeowner to the lender for financing. The contractor may mislead the consumer about the work to be performed, fail to complete the work as agreed, damage the property, or fail to obtain required permits.

Current law prohibits all of these practices. In addition, under the Federal Trade Commission's "Holder in Due Course Rule," similar state law provisions, and HOEPA (for HOEPA loans), the lender will generally subject to the same claims and defenses that the consumer has against the contractor (up to the amounts that the consumer has paid on the contract). Thus, if the work is not completed in a satisfactory manner, the consumer will not be responsible for full payment.

As a result of this exposure, subprime mortgage lenders use devices such as joint proceeds checks and progress payments to ensure that home improvement contractors perform the work properly. We would recommend that all lenders these practices.

Falsified or Fraudulent Applications; Forgery of Loan Documents; and Inflated Appraisals

An unscrupulous broker or lender may convince an unsophisticated borrower who cannot repay a loan to sign a blank application form. The broker or lender then inserts false information on the form, claiming income sufficient to make the payments, and sells the loan to an investor on the basis of the false information. Alternatively, the "predatory" broker or lender may simply forge the borrower's signature. Another fraudulent practice is for the broker or lender to collude with a corrupt appraiser to deliver an appraisal that exceeds the true value of the property. The investor then purchases the loan on the basis of the inflated appraisal.

All of these practices have two things in common—

- They are illegal under current law; and
- The investor is a victim along with the borrower, since the loan will eventually default and the investor will lose most or all of its investment.

Although legitimate, mainstream lenders maintain extensive procedures to avoid being caught in scams of this type, they are sometimes victimized by fraud by "predatory lenders." We recognize that more can be done—CMC's plan for addressing predatory lending includes the creation of a nationwide registry that would report on licensing status and disciplinary actions, so that brokers and companies who are caught engaging in fraud in one jurisdiction could not simply relocate to another area.

Incapacitated Homeowners

There have been allegations that predatory lenders make loans to homeowners who are mentally incapacitated. Since the homeowner does not understand the nature of the transaction, the end result is default and foreclosure.

Under long-standing contract law principles, a mortgage loan in which the borrower was incapacitated at the time of signing is unenforceable. Entering into such a transaction may also represent civil or criminal fraud.

As noted, subprime lenders are not in the business of making loans that are likely to default, and major lenders maintain procedures to avoid originating or purchasing loans in which the borrower lacks the legal capacity to enter into a contract.

Acceptable Practices That Are Subject to Abuse

The second type of alleged predatory lending consists of practices that are not illegal or unacceptable but may harm consumers when used in abusive ways.

Mortgage Broker's Fees and Kickbacks (Including Yield Spread Premiums)

A prominent target of critics of "predatory lending" has been the yield-spread premium —compensation paid to the broker through an increase in the interest rate. Yield spread premiums have been the subject of extensive class-action litigation in which plaintiffs have argued that this form of compensation is illegal under the prohibitions in RESPA against kickbacks and fee-splits.

Yield spread premiums can be helpful to consumers. Paying a yield spread premium allows a lender to reduce the cash required to close the loan by financing closing costs through a higher interest rate. A borrower who understands the cost of the loan can choose between paying more of these costs upfront or over the course of a loan.

The appropriate remedy for any abuses of yield spread premiums is not to prohibit a practice that often benefits consumers. It is to provide more effective disclosures and improve the competitive environment so that consumers can make informed choices that serve their interests. If consumers understand their closing costs, including the broker's fees they are to pay, before they commit themselves to a transaction and lenders are allowed to compete in providing ancillary settlement services, the broker's receipt of a yield spread premium is irrelevant to the consumer's shopping decision. Importantly, we note that the Mortgage Bankers Association of America and the National Association of Mortgage Brokers have encouraged the use of a form, developed jointly by those organizations, that explains the broker's role.

Prepayment Penalties

Another practice that is often criticized as "predatory" is the imposition of a prepayment penalty—a fee for paying off the loan before some specified time. In most instances, the penalty is reduced over time until it is finally phased out completely.

Legitimate lenders use prepayment penalties to protect themselves against the risk that the borrower will prepay the loan before the lender has recovered its origination costs. A prepayment penalty is one way for a lender to hedge against that risk as well as other financial risks that can occur from early prepayment of the loan. The benefit of reduced prepayment risk can be passed on to the borrower in the form of lower points or a lower interest rate. If a lender is not allowed to impose a prepayment penalty, then it may not be able to offer a zero- or low-closing-cost loan or it may have to increase its rates to be profitable.

On the other hand, an unscrupulous lender can use a prepayment penalty to lock a consumer into an undesirable loan. The CMC believes that the appropriate remedy for the "predatory" abuse of prepayment penalties is to ensure that borrowers understand that a loan with a prepayment penalty is an option that allows them to reduce their interest rate or upfront costs, not a requirement to obtain the loan. In addition, under the CMC's mortgage reform proposal, no prepayment penalty would be permitted after five years from the date of the loan. However, prepayment penalties would be authorized during this five-year period, notwithstanding state law. Any prepayment penalty permitted would be limited to a maximum of six months' interest on the original principal balance.

Making Unaffordable Loans (Asset-Based Lending)

Another common allegation is that predatory lenders make loans on the basis of the value of the property, disregarding the borrower's ability to pay and in fact anticipating that the borrower will default and the lender will foreclose.

CMC members and other responsible subprime lenders are not in the business of making loans that borrowers cannot repay. Foreclosing on a house is costly, time-consuming, and almost always results in significant losses to the lender. As discussed in greater detail under Tab 3, many subprime loans are now sold into the secondary market, and the rating agencies insist that such loans meet underwriting standards.

For those reasons, the CMC supports, in principle, the existing HOEPA rule against engaging in a pattern or practice of lending without regard to repayment ability. In practice, however, it is difficult to craft specific rules to prevent such "asset-based" lending that reliably apply to all situations. Attempts to specify static rules regarding each borrower's repayment ability are likely to be counterproductive and injure the very borrowers they are intended to protect. For example, one common proposal is to establish a presumption that a borrower with a debt-to-income ratio ("DTI") above a certain cutoff, such as 50%, lacks repayment ability. This rule seems to make sense until a lender encounters a borrower who currently is meeting her obligations with a DTI of 65% and wants a loan that would reduce her DTI to 55%. Moreover, a DTI that indicates an excessive debt load in a rural area may reflect the average in areas such as New York City or San Francisco with very high housing costs.

In addition, setting a cutoff for DTI at any particular level ignores differences in borrowers' circumstances that affect the debt load they can carry. At one extreme, an individual with a very high income, $1 million/year for example, and few family obligations can easily afford to make high monthly payments and still have enough to meet other living expenses. At the other extreme, a borrower with a low level of income and many dependents may not be able to make mortgage payments that represent a high fraction of his or her income.

Another proposed remedy for asset-based lending is to institute "suitability" rules that create lender liability for making an individual loan if, in hindsight, the lender should have anticipated that the borrower would default. For a mainstream subprime lender that already makes every effort to avoid making loans that go into default, the effect of such a rule will be to increase the costs of foreclosure by requiring the lender to absorb both the losses on the loan itself and the cost of settling the claim that it made an unsuitable loan. These costs will ultimately be passed onto borrowers in the form of higher loan costs or reduced credit availability.

High Points and Fees: Padding Closing Costs; Inflated Appraisal Costs; Padded Recording Fees; Bogus Broker Fees; and Unbundling (Double-Charging for the Same Service)

One of the major sources of criticism of and litigation against the subprime lending industry has been fees paid to mortgage brokers and to other participants in the mortgage process such as appraisers. For example, critics allege that lenders overpay mortgage brokers in comparison to the services the brokers provide or require an expensive appraisal when a "drive-by" evaluation would suffice. Critics also note that the actual amount of these costs (as opposed to an estimate) is not disclosed in advance of settlement, when the borrower still has the opportunity to shop for a better deal or negotiate an improvement in the current one.

Although the CMC agrees that borrowers should not have to pay for services that are not needed or not provided, we believe that a focus on the specific components of the cost of the mortgage is misplaced. Ultimately, the borrower is concerned with total costs (closing costs and interest rate) and not with the relationship among the different providers of settlement servicers or the cost of each individual component of the loan.

The CMC also agrees that present disclosure requirements do not give borrowers accurate and understandable information about the costs of obtaining a loan when they are in a position to use it. In some instances, current requirements may actually have facilitated abuses—as when an unscrupulous lender allegedly misrepresented the TILA-required "amount financed" (which does not reflect loan fees deducted from the proceeds) as if it were the total amount of the loan.

But the CMC believes that it is ineffective to combat excessive loan fees through ever-increasing scrutiny of the practices of settlement service providers and the relationships among them. A more sensible approach—the one taken in the CMC's mortgage reform proposal—would be to eliminate the disincentives in current law that prevent mortgage originators from offering a single, guaranteed price for all settlement services, and then impose a requirement mortgage originators to honor that commitment. Borrowers have no way of knowing what a service such as an appraisal or flood certification "should" cost, yet current law has created an elaborate system of disclosure and monitoring of such costs that is of very little value to most consumers.

Credit Insurance

Consumer advocates often assert that credit insurance products are of little or no benefit to consumers. In fact, while credit insurance is clearly not a good choice for all consumers, lender-provided credit insurance meets a consumer demand that is not met elsewhere in the marketplace. Independent insurance agents are often not interested in providing insurance to subprime borrowers in the relatively small amounts characteristic of a second mortgage loan. In addition, the liberal eligibility standards and convenience of purchasing the insurance are attractive to some subprime customers.

An unscrupulous lender can abuse the credit insurance product by selling it to a consumer who does not want or need it, based on the misrepresentation that insurance is required to obtain a loan. But a report on subprime lending shows penetration rates for single-premium credit insurance ranging from 28.3% for first-mortgage loans to 47.9% to second mortgages.[7] These statistics do not support the common assertion that credit insurance is being foisted on unwilling consumers.

Moreover, abusive credit insurance practices are illegal under current law. TILA currently permits a creditor to exclude credit insurance from the finance charge and annual percentage rate only when the lender discloses in writing that it is voluntary and the consumer consents to the purchase by signing or initialing the disclosure form.[8] Misleading consumers about credit insurance would also violate the Federal Trade Commission Act and similar state laws.

Voluntary credit insurance helps to address an unmet demand for life and disability insurance. About 25% of all U.S. households have no life insurance coverage, and about 40% of single parent households and households with annual incomes below $35,000 are completely uninsured. About 50% of all households are uninsured. The Department of Housing and Urban Development estimates that 46% of all foreclosures on conventional mortgages are caused by borrower disability and that 33% of Americans will suffer a serious disability between ages 35 and 65.

Single-premium credit insurance—in which the cost of the insurance is financed as part of the total cost of the loan—has been particularly controversial. The CMC members and other large lenders have modified their sales policies in response to concerns about the marketing of this product. Our members are offering a monthly-premium product and instituting a liberal cancellation policy.

The CMC's mortgage reform proposal, discussed above, includes a number of other protections related to credit insurance. There would be a clear and conspicuous disclosure given to the consumer that the insurance is voluntary and that it may be cancelled at any time with a refund of unearned premiums. Monthly-pay insurance could also be sold at or before closing. In both situations, there would be a notice after closing

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[7] *See* Michael E. Staten and Gregory Elliehausen, *The Impact of The Federal Reserve Board's Proposed Revisions to HOEPA on the Number and Characteristics of HOEPA Loans* at 12 (July 24, 2001).

[8] 12 C.F.R. § 226.4(d).

that the borrower may cancel the insurance at any time. Refunds of unearned premiums would be based on the actuarial method, not the less favorable Rule of 78's.

Loan Flipping

Loan flipping is the practice of an unscrupulous broker or lender repeatedly convincing the borrower to refinance in order to get a small amount of cash back. The broker or lender then receives additional points and fees. Consumer advocates often argue that it would be better for the consumer to take out a second, junior loan than to refinance the entire obligation. While that may be true in many instances, there are other situations in which the rate and terms on a new first mortgage are more desirable than the combination of retaining the existing first mortgage and obtaining a new second mortgage.

Loan flipping is another example of a practice that is easy to condemn in theory but difficult to prevent through a single rule that can be applied to all situations. One approach, taken in several state anti-predatory laws, is to require a demonstrated "net benefit" to the borrower before the same lender can refinance a loan. The difficulty in this approach is its subjectivity, which could leave lenders exposed to litigation if they could not demonstrate an adequate net benefit.

The CMC's mortgage reform proposal would limit the financing of closing costs and points on HOEPA loans to 3% of the loan amount for refinancings or equity loans entered into within twelve months of a prior financing. The rationale for this approach is to reduce the lender's incentive to flip HOEPA loans. Borrowers who must bring cash to closing to pay costs over the 3% are less likely to be "flipped" numerous times. At the same time, the CMC believes that 3% should be sufficient to allow for refinances to take advantage of declining interest rates.

Arbitration Clauses

Many consumer credit contracts—including many subprime mortgages—include a provision requiring that disputes be resolved through arbitration rather than through the lengthy process of litigation in the courts. Consumer advocates have asserted that binding arbitration clauses are inherently unfair, and there is no question that such a clause could be abused by erecting insuperable obstacles to a consumer's obtaining relief. But the U.S. Supreme Court has upheld the use of such clauses even when the case involves "claims arising under a statute designed to further important social policies," so long as the consumer can vindicate the rights granted under the law before the arbitrator.[9]

The Supreme Court noted in another case that arbitration benefits consumers in many ways:

> "[A]rbitration's advantages often would seem helpful to individuals, say, complaining about a product, who need a less expensive alternative to litigation. See, *e.g.,* H.R. Rep.

[9] *Green Tree Fin. Corp. v. Randolph,* 531 U.S. 79, 90, 121 S.Ct. 513, 521 (2000).

> No. 97-542, p. 13 (1982) ('The advantages of arbitration are many: it is usually cheaper and faster than litigation; it can have simpler procedural and evidentiary rules; it normally minimizes hostility and is less disruptive of ongoing and future business dealings among the parties; it is often more flexible in regard to scheduling of times and places of hearings and discovery devices . . .')."[10]

In place of long, drawn-out proceedings in which the attorneys' fees often dwarf any nominal amount received by consumers, an arbitration clause offers consumers speedy access to a neutral forum that can resolve their dispute with the damages being paid to the consumer, rather than attorneys. The one group that clearly does not benefit from reasonable arbitration clauses in consumer contracts is the class-action trial bar.

Balloon payments and Negative Amortization

Consumer advocates often characterize two loan structures—*balloon payments* and *negative amortization*—as types of predatory lending. In a balloon payment loan, the monthly payments do not fully amortize the amount of the loan, resulting in a large final payment. In negative amortization, the monthly payments are insufficient to pay the interest that accrues on the loan, and the difference is added to the principal. Balloon payments are restricted and negative amortization is prohibited under HOEPA.

We recognize that both of these structures can be used in an abusive manner. If the broker or lender misleads the borrower about the nature of a balloon loan or the final payment is due in an unreasonably short time, the homeowner may not be able to afford the balloon payment and may either lose the home or be forced to refinance on unfavorable terms. A borrower who does not understand the nature of negative amortization may face similar negative consequences.

At the same time, both of these loan structures can be helpful to some consumers. Balloon payments can benefit borrowers by allowing them to obtain lower-cost credit than they would otherwise qualify for. A balloon note can be particularly helpful to a borrower who expects to move to a new location within the period of the balloon mortgage. Such a mortgage would be less expensive than a fixed-rate, long-term mortgage loan for the consumer.

Negative amortization, by definition, reduces the monthly payment and may make a loan more affordable to a borrower with significant equity but insufficient income to qualify for a standard loan. Congress has recognized the benefits of one form of negative-amortization loan—the reverse annuity mortgage—by exempting such loans from the general prohibition against negative amortization in HOEPA.

Thus, further blanket restrictions on these loan structures, while protecting some consumers, could prevent others from obtaining loans that fit their financial circumstances.

[10] *Allied-Bruce Terminix Cos. v. Dobson,* 513 U.S. 265, 280, 115 S.Ct. 834, 843 (1995).

MORTGAGE LENDING AND SERVICING PROCESS

In this section of our testimony, we describe the mortgage origination, funding and servicing process, its participants and the compensation each receives.

Mortgage Origination

Application Processing

In some instances, the borrower seeks out the source of financing, or responds to direct mail or other direct marketing. In others, the borrower is referred by a real estate broker or home improvement contractor. In both prime and subprime lending, there are two major distribution channels for distributing mortgage credit:

- In the *retail* channel, the lender offers mortgage loans directly to borrowers, through a sales force of loan officers. Loan officers are employees of the lender/servicer who counsel the applicant, take and process the application, obtain verification documents, order the appraisal of the property, and prepare the loan for *underwriting* (evaluation).

- In the *wholesale* channel, the lender does not deal directly with the consumer. Instead, the lender and consumer work though an intermediary.

  The types of intermediaries in the wholesale channel include the following:

- A *mortgage broker* is usually an independent contractor that offers loan products from a number of wholesale lenders. The mortgage broker generally does what the loan officer does (described above), i.e., discusses loan options with the borrower, takes an application, and usually processes the loan—obtains a credit report and appraisal, verifies employment and assets, and otherwise prepares the loan for underwriting.

- A *correspondent lender* not only takes the application and processes the loan, but also funds the loan. The correspondent then sells the loan to a wholesale lender, usually under a previous commitment of the wholesaler to purchase a certain amount of loans at an agreed-upon interest rate.

- A *home improvement contractor* may act as, in effect, the originating lender, taking an installment sales contract in payment for the goods and services provided and then discounting (selling) the contract to a lender. In that situation, the application is usually processed and underwritten by a mortgage broker or mortgage banker.

Underwriting

Historically, the next step after taking and processing the application was for the lender to *underwrite* (evaluate and approve or reject) the application. With the advent of credit scoring and automatic underwriting systems, much of the evaluation of an applicant is now accomplished during the application stage, but loans are still subject to final underwriting approval by the lender, including the underwriting of the property to be used as collateral for the loan.

There are a number of factors used to assess risk. Typically, they include:

- Credit-Related Factors
- Mortgage or Consumer Debt Payment History
- Bankruptcies, Foreclosures or Judgments
- Borrowing Capacity Factors
- Debt-to-income ("DTI") requirements (the borrower's debt load, including the proposed loan, compared to his or her income)
- Loan-to-Value ratio (the amount of the proposed loan compared to the appraised value of the property)
- Non-standard Collateral
- Mixed-use commercial/residential properties

Closing

Once the loan has been underwritten and approved, the closing is scheduled. The lender generally has certain conditions to closing which must be met, including assurance that (i) the borrower has clear title to the property (through title insurance), (ii) the borrower has other required insurance on the property, such as flood insurance or property and casualty insurance, and (iii) the borrower has sufficient funds to close the loan. At the closing, the borrower executes the mortgage note evidencing the debt and the mortgage on the property in exchange for the closing proceeds. Funds for points and closing costs, payable by the borrower to the lender, the mortgage broker or correspondent, or third party settlement service providers, are collected either directly from the borrower or from the loan proceeds.

Funding: Holding the Loan In Portfolio or Selling into the Secondary Market

After the loan has been underwritten and closed, the lender will either hold the loan in its portfolio or to sell it in the *secondary market* either in a *securitization* or a whole loan sale. If the loan is held in portfolio, the lender is effectively the investor in the loan. In a securitization, a pool of loans is used to back an issuance of securities to be traded in the securities market, or an undivided interest in the loans themselves is sold to investors. There are costs to the lender in the execution of both a whole loan sale and an issuance of mortgage-backed securities.

Mortgage-backed securities are first analyzed and rated by an independent bond-rating agency such as S&P or Moody's. The rating agency's evaluation includes computation of the average credit scores of the loans in the pool to be securitized as well as a due diligence review of the lender's procedures. The lender will generally have to promise that proper underwriting procedures were followed. If it fails to keep that promise, the investors will often have the right to force the lender to repurchase the loan in the event of default.

Even when a lender expects to retain a loan in portfolio rather than sell it into the secondary market, prudent risk management dictates that the lender complies with appropriate underwriting criteria to ensure that the borrower can afford to repay the loan.

Investors, whether they be secondary market investors or portfolio lenders will only make a return on their investment if the loans that they fund perform.

Servicing

Whether the loan is held in the lender's portfolio or sold in the secondary market, the loan must be serviced, that is, the monthly payments must be collected, payments must be passed through to the investor, and delinquencies, defaults, bankruptcies and foreclosures must be dealt with, as they arise. On first mortgage loans, the servicer must collect funds for tax and insurance escrow accounts and disburse those funds to the taxing authorities and insurance companies, in accordance with state and federal law and the mortgage contracts. Second lien loans generally do not involve escrow accounts.

Except for correspondent lenders, lenders often retain the servicing responsibilities on loans they make and fund. Sometimes they conduct the servicing functions through a contractor in a "subservicing" arrangement. In other cases, they will sell the servicing rights (including the rights to servicing fees) and responsibilities to another servicer.

Compensation

Compensation to Brokers and Correspondent Lenders

The mortgage broker or correspondent may receive its compensation for the borrower, the lender, or both. Compensation by the borrower, if any, is in the form of points or an application fee, an origination fee, or a broker fee.[11] All or part of the application fee may be used to pay for the credit report and appraisal. Compensation paid by the lender reflects the difference between the retail rate charged to the borrower and the lender's wholesale rates. When a correspondent lender sells a loan to a wholesaler, the price reflects this compensation and may exceed the amount that the correspondent lender advanced to the borrower. When a mortgage broker brings a loan to a lender, the

[11] Some originators also charge a lock-in fee for locking-in an interest rate for the borrower.

lender may pay a "yield spread premium" that is equivalent to the difference in value between a loan at the retail rate and one at the wholesale rate.

The points and fees paid to a mortgage broker or loan correspondent cover the costs of processing the application and underwriting a subprime loan. These costs are generally higher than for prime lending, for several reasons:

- First, by definition, a subprime borrower is likely to have issues that must be resolved through manual verification. For example, the borrower's explanations for late payments or for a reduction in income must generally be independently verified—an expensive, hands-on process.

- Second, subprime loans tend to be for somewhat lower amounts than prime loans, thus the cost per loan tends to be proportionally higher.[12] Many processing and underwriting costs are fixed regardless of the size of the loan.

- Third, as "lenders of last resort," subprime lenders receive a much higher proportion of applications from applicants who do not qualify even for subprime loans. Accordingly, subprime lenders have much higher rejection rates than do prime lenders.[13] Brokers and lenders generally do not recover the cost of processing rejected applications through fees charged to rejected applicants and must make up some of those costs through revenues from approved loans. Thus, the cost of processing loan applications that are eventually denied raises per-loan processing and underwriting costs on approved subprime loans.

As noted, in the wholesale loan market, the mortgage broker or correspondent lender bears many of these processing and underwriting costs. The broker or correspondent also has advertising and marketing costs that would otherwise be borne by a retail lender. Either the borrower or the lender, or both, must compensate the broker or lender for these expenses.

Compensation to Lenders/Servicers

Lenders who originate loans through a retail channel receive compensation from borrowers in the form of am application fee, a lock-in fee if applicable, and points and fees paid at closing. In addition, if a lender sells the loan in the secondary market, it will receive some compensation on the execution of that sale, whether in a whole loan sale or a securitization.

[12] According to the same study, 1998 HMDA data show that subprime lenders had an 11.25% share of the total mortgage market in terms of number of loans, but only 8% of the dollar volume.

[13] The study of 1998 HMDA data showed denial rates for subprime lenders of 50.0% in purchase loans, 59.5% in refinances, and 69.1% in home improvement lending. Comparable figures for prime lenders were 11.8% in purchase-mortgage lending, 13.6% in refinances, and 33.2% in home improvement lending.

The compensation a lender receives from the borrower through fees and through a secondary market sale often do not fully cover, or cover only by a small margin, the costs of originating and, if applicable, transferring the loan. Thus, the lenders' profits come principally from its servicing earnings, and there is a great incentive for the servicer to do everything it can to keep the borrower paying the loan on time. Defaults interrupt the servicer's income until the borrower resumes making payments. A foreclosure not only stops the income, but it results in the added costs of prosecuting the foreclosure. Not all of these costs are entirely reimbursed by the investor. In fact, foreclosures are costly, time-consuming, and almost always result in large losses to the lender/servicer.

Servicing income is also the principal component of earners for subprime lenders/servicers. The upfront fees are higher because originating a subprime loan is more costly. Upfront fees are also higher because lender/servicers need to defray the higher origination costs to compensate for the shorter period over which these loans will be serviced. Subprime loans refinance more quickly because borrowers, as they become qualified for prime loans, refinance into a prime loan product. Moreover, subprime loans have higher default rate and are more expensive to service. Those additional costs need to be built into the price charged to consumers. Nonetheless, subprime servicers have the same very high incentive to do everything they can to keep the borrower paying the loan. Conversely, they have no incentive whatsoever to get the borrower into a loan that he or she cannot afford to repay. Nor do they have an incentive to get the borrower into a loan with a very high interest rate that is more likely to refinance more quickly. In either case, the servicing income on that loan comes to an end.

Compensation to Investors (Portfolio Lenders or Secondary Market Investors)

Investors earn the interest paid on the loan by the borrower over the life of the loan, minus the fraction of a percent that is paid to lender/servicers that service the loan. Like lender/servicers, mortgage market participants that fund loans, whether they are portfolio lenders or secondary market investors, do not have an economic incentive to fund loans at above market interest rates because those loans will refinance more quickly. (Of course, consumers have the choice of agreeing to a lower market interest rate if they agree to a prepayment penalty.)

Like lender/servicers, investors earn money when consumers are provided loans they can afford to repay over time.

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Daniel A. Mica
President & CEO

November 4, 2003

The Honorable Robert Ney
2438 Rayburn House Office Building
Washington DC, 20515

Dear Representative Ney:

On behalf of the Credit Union National Association (CUNA) and the nation's nearly 10,000 credit unions and 83 million credit union members, I would like to commend your subcommittee for holding a joint hearing on Abusive Mortgage Lending and Access to Credit this Wednesday, November 5th. For inclusion in the record, I have attached CUNA's recently adopted policy on predatory lending, the *Anti-Predatory Lending Law Guidelines,* as well as our voluntary guidelines on lending practices.

CUNA and its member credit unions are committed to helping our members create a better economic future for themselves and their families. CUNA has long advocated for the elimination of lending practices that are intentionally structured in a manner that is deceptive and disadvantageous to borrowers, and have looked for new ways to reach out to the underserved communities to bring them into the financial mainstream and away from unscrupulous lenders.

In February 2003, CUNA's State Issues Subcommittee of the Governmental Affairs Committee issued a set of guidelines to be used as a tool to determine whether or not federal legislation pertaining to predatory lending practices can be supported by CUNA and its member credit unions. These guidelines consist of sixteen must-have provisions that should be incorporated into legislation to be considered an effective anti-predatory lending bill.

A few of the must-have provisions CUNA supports include:

- **State and Local Preemption**—The preemption would be supported only if the other fifteen provisions are part of the proposed legislation. The preemption is very important because it would be impossible for a mortgage lender to operate under a myriad of different state and local rules without passing on the excessive costs of such complex compliance to consumers.

- **Limits on the Financing of Points and Fees**-- Some abusive lenders have mislead borrowers as to the true cost of their loan by financing the fees.
- **Prohibition on "Flipping" Loans to the Detriment of the Borrower** -- Specific language to describe how it will be determined whether a refinance will have a "reasonable net benefit" for the borrower, and not for the purpose of enriching the lender.
- **Prohibition on Balloon Notes**-- They are widely abused in the high-cost mortgage industry where abusive lenders use them to set up "flips" and other types of abusive practices.
- **Requirement to Consider Borrower's Ability to Repay Loan**-- It has been charged that some lenders make loans based not on the ability of the borrower to repay, but rather on the equity the borrower has in their home.
- **Requirements to Encourage Credit Counseling**-- Promotion of financial literacy is one of the foremost solutions for protecting consumers from poor credit choices.
- **Credit Reporting Requirements**-- Accurate reporting to credit reporting agencies is very important in the battle to curb predatory lending practices.

The *Anti-Predatory Lending Law Guidelines* also detail provisions that must not be included in any CUNA-endorsed predatory lending legislation, as well several provisions that are either recommended or deemed as acceptable by credit unions.

CUNA and its member credit unions are eager to see the elimination of abusive predatory lending practices, and have taken voluntary efforts to educate our members and provide them with fair and sound alternative products. Enclosed is a copy of the *CUNA Member Credit Union Mortgage Lending Standards And Ethical Guidelines*, a set of voluntary guidelines to be adopted by credit unions across the country. These guidelines were designed to help emphasize credit unions' concern for consumers and further distinguish credit unions as institutions that care more about people than money.

It is our hope that we will have allies in our efforts to assure that all consumers have access to credit products that do not unfairly take advantage of their circumstances. CUNA and its member credit unions appreciate any consideration that your subcommittee and the Financial Services Committee may give to the *Anti-Predatory Lending Law Guidelines* and *the CUNA Member Credit Union Mortgage Lending Standards And Ethical Guidelines* when developing anti-predatory lending legislation.

Sincerely,

Best regards!

Daniel A. Mica
President & CEO

PROPOSED CUNA MEMBER CREDIT UNION MORTGAGE LENDING STANDARDS AND ETHICAL GUIDELINES

Issue: Homeowners across the country, seeking to borrow against the equity in their property, may be forced to pay excessive rates and fees, be subjected to other abusive borrowing activity, or be at risk of actually losing their homes, if they fall prey to unscrupulous lending practices known as predatory lending. Such borrowers are often elderly or other individuals facing significant financial demands who are anxious to have access to credit and thus, vulnerable to unconscionable demands and requirements of the predatory lenders.

Credit Union Concerns/Interests

Credit unions have a proud history of service to their members and provide products that meet members' needs and are in members' best financial interests. As member-owned, democratically controlled financial cooperatives, credit unions want to help protect consumers from abuses of predatory lending in the financial marketplace, even though credit unions themselves offer products that are fairly priced, with reasonable terms and conditions.

Under the Federal Credit Union Act and/or regulations from the National Credit Union Administration, more stringent rules apply to credit union mortgage lending than apply to commercial bank home loan products. For example, federal credit unions are subject to a 15% usury rate ceiling, which may be adjusted up to 21% and now stands at 18%. Also, federal credit unions may not charge prepayment penalties. A chart showing the differences between credit unions and bank home mortgage lending rules is attached. State provisions vary, but may state chartered credit unions operate under similar limitations.

The Credit Union National Association, the largest trade association representing credit unions, condemns the practice of predatory lending. CUNA's Board of Directors calls on every CUNA member credit union to adopt home equity lending standards and ethical guidelines that will help emphasize credit unions' concern for consumers and further distinguish credit unions as institutions that care more about people than money. CUNA will work with key policymakers, including state and federal credit union regulators, to ensure they support an approach that is designed to increase awareness of the predatory lending problem and highlight credit unions role as not-for-profit, consumer-owned financial institutions.

Guidelines and Ethical Standards

Credit unions abhor predatory lending and seek to protect consumers from such abominable practices. Predatory lending **includes home equity-stripping** loan products with one or more of the following characteristics:

- Interest rates that are significantly above market rates and which are not justified by the degree of risk involved in providing the credit;
- Excessive balloon payments that require refinancing at a rate that is more than the rate on the existing note;
- Lending without regard to whether the borrower has the ability to repay;
- Requirements for frequent refinancings of the loan resulting in additional costs to the borrower and significant erosion of the borrower's equity;
- Prepayment penalties, **in excess of actual costs incurred and unpaid**;
- Exorbitant fees and insurance premiums that the borrower may be required to finance, further jeopardizing equity;
- Misleading or false advertising.

Predatory lending does not encompass legitimate products **such as reverse mortgages** or risk-based lending recognized by fair lending and fair credit statutes that allow financial institutions to price loan products by taking into consideration the risk to the institution in making a loan.

Recognizing that predatory lending is fully inconsistent with the philosophy and principles unique to the credit union system, credit unions adopting these home equity lending guidelines and ethical standards agree to:

Emphasize Member Education

- Provide a copy of these standards to member/borrowers, as applicable;
- Educate members regarding the dangers and abuses of predatory lending by offering counseling and other useful information about the lending process;
- Inform members about the differences and advantages associated with credit union lending products, such as applicable usury ceilings, lack of prepayment penalties;
- Inform borrowers about all applicable lending products the credit union offers;
- Assist borrowers in understanding applicable loan disclosures, rates, fees and terms, including any rights or rescission;

Meet Members' Borrowing Needs

- Ensure home equity loan products meet the consumer's borrowing needs and ability to repay, consistent with credit union loan policies and legal requirements;

Prohibit and Refrain From Abusive Practices

- Exclude terms and conditions that are not justified by the documented risk to the credit union of extending the loan;
- Exclude interest rates that are higher than market indices, **except as proportionate to comparable Treasury securities** based on the borrower's credit history, income and other indicators of ability to repay the loan;
- Prohibit refinancing of balloon payments at a higher rate than on the original note when justified by market conditions or the risk of making the loan;
- Exclude fees and insurance premiums from the amount to be financed; (does not include extended warranty program)
- Prohibit **charging for or financing** insurance products or unrelated goods or services without the consent of the borrower;
- Ensure lending staff are well trained to avoid potentially misleading statements in connection with a loan transaction;
- Prohibit loan "flipping", which is providing a loan to a borrower to refinance an existing home loan when the new loan does not have a net benefit to the borrower, taking into consideration the terms of both loans and the borrower's circumstances;
- Exclude mandatory arbitration clauses that limit the rights of borrowers to seek redress in court should problems arise.

Support Efforts in the Marketplace to Prohibit Predatory Lending

- Follow FNMA and FHLMC anti-predatory lending guidelines, which include key provisions such as:

    - Loans purchased may not have points or fees that generally exceed 5%, **excluding discount points**;
    - Prepaid single-premium credit life insurance may not be sold in connection with loans purchased;
    - Lenders which sell to FNMA or FHLMC must report on loans they are servicing each month;
    - Waivers should not be allowed from the requirement that servicers maintain escrow accounts for the payment of taxes, insurance premiums, etc. for borrowers with "blemished" credit records.

For more information on these guidelines, contact Eric Richard at 202-508-6742 or Mary Dunn at 202-508-6736.

Anti-Predatory Lending Law Guidelines & Comparison

State Credit Union Subcommittee
Of the
Credit Union National Association

February, 2003

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CUNA's State Credit Union Subcommittee
Anti-Predatory Lending Legislation Guidelines
January 2003

In 1994, Congress passed the Home Owners Equity Protection Act (HOEPA) to address "reverse redlining". This term was used to describe the targeting of residents in certain geographic boundaries, often based on income, race, or ethnicity, for credit on unfair terms. Testimony during Congressional hearings indicated that communities lacking access to traditional lending institutions were being victimized through the use of unfair credit terms by second mortgage lenders, home improvement contractors, and finance companies who were peddling high-rate, high-fee home equity loans to cash-poor homeowners. HOEPA was passed to protect borrowers who might enter into home equity scam transactions.

In 1998, the credit union system in North Carolina determined that abuses were still occurring in the subprime lending market. Consequently, the credit unions in that state championed an anti-predatory lending bill that would expand the protections of HOEPA. The North Carolina legislation passed and since that time, bills addressing subprime mortgage lending practices have been introduced in many states, as well as by Congress.

CUNA's State Credit Union Subcommittee supports the prohibition of predatory lending practices that some mortgage brokers and mortgage lenders across the country are using to harm consumers, and in some cases, foreclose on their homes. The subcommittee supports eliminating lending practices that are intentionally structured in a manner that is deceptive and disadvantageous to borrowers, without hampering legitimate mortgage lending programs or consumers' access to credit for home purchases.

There are several anti-predatory lending bills currently being considered at the state and federal levels. These bills are highly controversial as consumer groups advocate for strict prohibitions on several lending practices and subprime mortgage lenders argue that these restrictions will put them out of business, thus limiting available credit for consumers with less than perfect credit histories. Credit union groups throughout the country have found themselves in the middle of this controversy trying to find the balance that will allow legitimate lenders access to creative lending practices to meet an individual's needs and at the same time prohibit abusive lenders from using these same practices to take advantage of and harm borrowers.

The members of CUNA's State Credit Union Subcommittee carefully reviewed and discussed various provisions of several anti-predatory lending laws and bills (see attached matrix). These bills range from the strictest consumer law in the country, the Georgia law, to the least restrictive, the existing HOEPA law. As a result of this discussion, the subcommittee members reached the following conclusions:

An effective anti-predatory lending bill must, at a minimum, include all of the following provisions for high cost mortgage loans:

- A State and Local Preemption
- Limits on the Financing of Points and Fees
- Prohibition on Financing Single Premium Credit Insurance
- Prohibition on "Flipping" Loans to the Detriment of the Borrower
- Limits on Prepayment Penalties
- Prohibition on Balloon Notes
- Prohibition on Structuring a Loan to Evade the effects of this Law
- Prohibition on the Acceleration of Debt at Creditor's Discretion
- Prohibition on Encouraging Default
- Prohibition on Penalty Interest Rate upon Default
- Prohibition on Modification and Deferral Fees
- Prohibition on Mandatory Arbitration Clause
- Requirement to Consider Borrower's Ability to Repay Loan
- Requirements for Home Improvement Contracts
- Requirements to Encourage Credit Counseling
- Credit Reporting Requirements

An effective anti-predatory lending bill <u>must not</u> include:

- "High Cost Mortgage" threshold less that 6% for 1st liens, 8% for 2nd liens, using Treasury securities of "comparable periods"
- Total ban on financing points and fees
- Prohibiting Late Fees for <u>All</u> Loans
- Anything Less than Existing Law Regarding the Financing of Excessive Advance Payments
- Anything Less than Existing Law Regarding Mandatory Arbitration

The following provisions are very important. Although credit unions should work to have these provisions included in any anti-predatory lending legislation, if the other 16 "must have" provisions are included, these provisions should not stand in the way of passing an effective anti-predatory lending law:

- Include "open-end credit plans" to the definition of "home loan";
- Omit specific numbers in a rebuttable presumption for ability to repay loan;
- Include "completion certification" requirement for Home Improvement Contracts.
- Omit difficult credit counseling requirements that could slow down mortgage process for borrowers.

The following provision represents a good idea that credit unions should support:

- Lowering the existing points and fees threshold that determines when a home loan is considered a "high cost mortgage" to match the current North Carolina law.

The following provisions should be acceptable and not opposed by credit unions:

- "High cost mortgage" threshold limits of 6% for 1st liens and 8% for 2nd liens, provided the language refers to Treasury securities of "comparable periods";
- Prepayment fees in first 36 months, when other conditions met;
- Balloon note exception for seasonal/irregular income;
- Prohibition on negative amortization, although it is already included in existing law;
- 5% limit on late fees;
- Reasonable access to "account balance" information;
- Prohibiting the encouragement of default for ALL loans;
- Credit counseling certificate from 3rd party
- Reasonable Right to Cure provisions for borrowers;
- Additional disclosures regarding the risks of high cost loans.

The following further describes the Subcommittee's conclusions:

An effective anti-predatory lending bill <u>must</u> include <u>all</u> of the following:

<u>A State and Local Preemption Provision</u> :
Although the members of the subcommittee strongly agreed that this preemption provision is in the best interest of credit unions and must be included in any anti-predatory lending legislation, it is conditioned on the inclusion of the other 15 provisions that the subcommittee determined <u>must</u> be in any credit union supported anti-predatory lending bill. The inclusion of a preemption provision is not meant to allow Congress to pass an ineffective anti-predatory lending bill, while preempting effective state laws. This subcommittee continues to be a strong advocate for state government and states' rights but concluded that, in this instance, preemption is very important because it would be impossible for a mortgage lender to operate under a myriad of different state and local rules without passing on the excessive costs of such complex compliance to consumers.

<u>Limits on the Financing of Points and Fees</u> :
It has been reported that some abusive lenders have mislead borrowers as to the true cost of their loan by financing the fees. In this way the borrower never has to actually hand over the thousands of dollars in fees, and the lender portrays the loan as a "no fee" loan. The subcommittee members agree with Senator Sarbanes' approach to this issue – there should be a cap on the amount of the points and fees that can be financed and prohibit any financing if the high cost mortgage is to refinance an existing high cost mortgage with the same creditor.

<u>Prohibition on Financing Single Premium Credit Insurance</u>
Paying for credit insurance in one lump sum at the beginning of the loan and having it rolled into the financing is disadvantageous to consumers. The subcommittee members agree with a ban on financing single premiums for credit insurance but conclude that monthly payments should be allowed. The subcommittee recommends language similar to the North Carolina law: "It shall be unlawful for any lender in a consumer home loan to finance, directly or indirectly, any credit life, disability, or unemployment insurance, or any other life or health insurance premiums; provided, that insurance premiums calculated and paid on a monthly basis shall not be considered financed by the lender."

<u>Prohibition on "Flipping" Loans to the Detriment of the Borrower</u>
"Flipping" occurs when borrowers are refinanced (usually repeatedly) for the primary purpose of enriching the lenders. The subcommittee agrees that prohibiting "flipping" must be included in any effective anti-predatory lending bill. However, the the members of the subcommittee want to ensure that no opportunities for a consumer to lower the cost of a subprime loan are unintentionally blocked by this provision. Some of the provisions reviewed by the subcommittee allowed refinancings as long as a "reasonable net benefit" was provided for the borrower. The subcommittee recommends that specific language be included to describe how it will be determined whether a refinance will have a "reasonable net benefit" for the borrower.

One example could be a version of Rep. Ney's bill which includes an exception to its refinancing limitations : " [the limitation on refinancing high cost mortgages] shall not apply if the finance charge for the balance of the prior existing high-cost mortgage exceeds the finance charge for the subsequent high-cost mortgage by an amount greater than the amount of the fees and charges imposed by the creditor for such subsequent mortgage."

<u>Limits on Prepayment Penalties</u>
According to AARP, the majority of subprime borrowers sign loans with prepayment penalties. These penalties can be problematic for borrowers because they are easily hidden since they are not collected until after the loan is closed. The subcommittee supports limits on prepayment penalties and recommends a combination of Senator Sarbanes' 2001 legislation and the North Carolina law, such as: "Prepayment penalty permitted within 1st 24 months; no prepayment if more than 3% of points and fees are financed; no prepayment fees for loans of $150,000 or less." The subcommittee is flexible on the specific numbers but agreed that these types of limitations would be preferable.

<u>Prohibition on Balloon Notes</u>
While balloon payments are useful for some borrowers, they are widely abused in the high-cost mortgage industry where abusive lenders use them to set up "flips" and other types of abusive practices. The subcommittee members support a complete prohibition on balloon notes for high cost mortgages as currently defined by HOEPA. The subcommittee further supports a disclosure, similar to the one included in Rep. Ney's bill, that alerts the borrower to this term of the loan and provides the amount of the balloon payment that will be owed by the borrower. The subcommittee members do not oppose an exception to accommodate seasonal/irregular income of borrowers.

<u>Prohibition on Structuring a Loan to Evade the effects of this Law</u>
The subcommittee members support this prohibition and recommend adding language, similar to Senator Sarbanes' 2001 bill, to the existing prohibition included in HOEPA. For example, "Prohibition on purposeful evasion of requirements for high cost mortgages by entering into reciprocal arrangements, dividing loan transactions into separate parts, or structuring consumer credit transactions to avoid requirements.

Also, "may not take any action that the Board determines, by regulation, to constitute a bad faith effort to evade or circumvent any requirement of the section regarding a consumer credit transaction."

Prohibition on the Acceleration of Debt at Creditor's Discretion
The subcommittee members support this prohibition and recommend language similar to Rep. Ney's bill: "Acceleration of debt at creditor's sole discretion prohibited unless default or due-on-sale clause, or any consumer act or omission that adversely affects creditor's interest."

Prohibition on Encouraging Default
It is reported that predatory lenders often "bait and switch" borrowers by promising them a good loan while successfully encouraging the borrower to stop paying their existing loans. Once the borrower is in default, he/she has little choice but to accept the high-cost loan. The subcommittee members find the practice of encouraging default on other loans to be an indefensible practice, and support its prohibition.

Prohibition on Penalty Interest Rate upon Default
On high cost loans, with interest rates typically close to credit card rates, risk is considered priced into the loan. However, according to AARP, some of these loans still seek to collect even more interest by charging a higher rate upon default. The subcommittee members support the prohibition of increasing the interest rate upon default, but recommend adding a clause included in the North Carolina and Georgia laws: "Does not apply to variable rates consistent with loan documents."

Prohibition on Modification and Deferral Fees
Due to the high cost of these loans, consumer groups argue against any additional fees after closing. The subcommittee supports a prohibition on modification and deferral fees, but recommends including an exception that would allow flexibility for borrowers to obtain better rates. For example, Rep. Ney's bill included : "unless modification results in a lower APR and the amount of fees must be comparable to fees imposed for similar consumer credit transactions that are not residential mortgage transactions or high cost mortgages." And Sen. Sarbanes' 2001 bill includes: "unless fee is in connection with an action that provides a material benefit to the consumer and the amount of the fee does not exceed (i) an amount equal to 0.5% of the total loan amount; or (ii) in excess of $300 when the total loan amount does not exceed $60,000."

The subcommittee is hesitant of the Sarbanes' provision because the phrase "a material benefit" is too be vague and potentially problematic.

Prohibition on Mandatory Arbitration Clause
The subcommittee supports a prohibition on a clause that would mandate arbitration as the only option for a borrower to seek restitution in a mortgage loan dispute. However the subcommittee also supports that an exception be included to allow borrowers choices that are in their best interest, such as the provision included in Senator Sarbanes' 2001 bill: "Prohibits mandatory arbitration, but does not limit the consumer's right to agree to arbitration or any other type of nonjudicial procedure at any time after a dispute or claim arises. No mortgage provision shall be applied or interpreted to bar a consumer from bringing an action in court for damages or relief in connection with any violation."

Another acceptable option could be Rep. Ney's safe harbor language: "Provides a safe harbor for provisions that (a) establish venue in Federal District Court where property is located; (b) complies with standards of nationally recognized arbitration organization; and (c) creditor bears all costs for first 2 days of arbitration."

Requirement to Consider Borrower's Ability to Repay Loan
It has been charged that some lenders make loans based not on the ability of the borrower to repay, but, rather, on the equity the borrower has in their home. It is argued that the only way for the lender to collect their charges is through foreclosure. The subcommittee supports the existing requirement in federal law with the additional provision included in Senator Sarbanes' 2001 bill: Require case-by-case assessment of ability to repay. One or more resident obligors must be able to make payments based on current and expected income, current obligations, employment

status, without taking equity into account. Adds requirement that creditor independently verify information.

The rebuttable presumptions included in most of the laws and legislation that the subcommittee reviewed were found to be helpful from a legal perspective, but the subcommittee members recommend exercising caution with the rebuttable presumptions because specific numbers can be misleading and result in unintended consequences.

Requirements for Home Improvement Contracts
One of the most abusive lending scams involves individuals posing as home improvement contractors who arrange for financing payable to themselves. Once they receive payment they halt work and leave the borrower with a binding debt, no home improvements and no recourse. The subcommittee members support existing federal law.

Requirements to Encourage Credit Counseling
The State Credit Union Subcommittee has been reviewing such issues as payday lending and predatory mortgage lending for the past 5 years. Although the strategies for protecting consumers from these poor credit choices have been complex, one foremost solution has been the promotion of financial literacy. The subcommittee members are strong advocates for requiring financial literacy in high schools as well as any other available forum. Consequently, the subcommittee requires that any anti-predatory lending bill supported by credit unions include a credit counseling provision.

That said, the subcommittee cautions against any credit counseling requirement that would put a hardship on the borrower or slow down the borrower's mortgage process, such as requiring a credit counseling course that is not conveniently available to the borrower.

The subcommittee prefers the language included in Senator Sarbanes' 2001 bill: "Before making a high cost mortgage, the creditor must provide: (1) all warnings and disclosures regarding the risks, (2) a separate writing recommending credit counseling; and (3) a written list of counseling services with addresses and numbers."

The subcommittee would also support other solutions such as a requirement that each high cost borrower view a HUD produced video explaining the risks of a high cost mortgage and how to shop for the best deal.

Credit Reporting Requirements
The subcommittee members agreed that accurate reporting to credit reporting agencies is very important in the battle to curb predatory lending practices. All legitimate lenders should already be doing this. The subcommittee supports the language included in Senator Sarbanes' 2001 bill, which adds to the Fair Credit Reporting Act the following provision: "Each creditor, and each successor to a creditor, who enters into a high-cost loan shall report the complete payment history, favorable and unfavorable, with respect to the transaction to a national consumer reporting agency at least quarterly."

An effective anti-predatory lending bill must not include:

A "High Cost Mortgage" threshold less that 6% for 1st liens, 8% for 2nd liens
The subcommittee members support additional restrictions, prohibitions and disclosures for "high cost mortgages", which are currently defined by federal law as loans with an interest rate of 8% or more above the Treasury rate for a comparable period for 1st liens, and 10% or more above the Treasury rate for a comparable period for 2nd liens.

The subcommittee does not agree that such additional restrictions, prohibitions and disclosures should apply to all home loans. In fact, applying these restrictions and prohibitions to all loans could limit borrowers' opportunities to craft a mortgage loan to best meet their individual needs and circumstances. For this reason, although the subcommittee members recommend the "high cost mortgage" thresholds in existing federal law (described above as 8% and 10%), the subcommittee members would not oppose lowering the thresholds to 6% or more above the Treasury rate for a comparable period for 1st liens, and 8% or more above the Treasury rate for a comparable period for 2nd liens. However, the subcommittee members would oppose any proposal to lower these threshold limits below 6% and 8%.

Total Prohibitions on Financing Points and Fees
While the subcommittee members support limiting the financing of points and fees (see above), they oppose a total prohibition on this practice. The subcommittee members expressed concerns that some consumers would be disadvantaged and shut out of legitimate financing opportunities.

Prohibiting Late Fees for All Loans
While the subcommittee members support limits on late fees, they oppose a prohibition of all late fees for all loans. The subcommittee agreed that late fees should be limited to no more than 5% of amount past due. Additionally, the subcommittee members noted that it will be very important that any provision addressing late fees be carefully drafted to ensure that any late fee is not added to the principal amount, and that no late fee will affect the account in such a way as to render subsequent payments short, or in effect late.

Anything Less than Existing Law Regarding the Financing of Excessive Advance Payments
The subcommittee members support existing law that prohibits the financing of more than two payments paid in advance and would oppose any new or additional language that could in effect limit the protections currently afforded consumers.

Anything Less than Existing Law Regarding Mandatory Arbitration
The subcommittee supports a prohibition on mandatory arbitration clauses and would oppose any language that could weaken this protection. For example, the subcommittee members found the opening paragraph included in Rep. Ney's bill to be too vague: "Prohibits oppressive, unfair or unconscionable arbitration clauses that are substantially in derogation of the rights of consumers."

The following provisions are very important. Although credit unions should work to have these provisions included in any anti-predatory lending legislation, if the other 16 "must have" provisions are included, these provisions should not stand in the way of passing an effective anti-predatory lending law:

Include "open-end credit plans" to definition of home loan
The subcommittee supports the provisions in the Georgia law, AARP's model bill and Senator Sarbanes' 2001 bill that include open-end credit plans in the definition of home loan for purposes of this legislation. The subcommittee members also support caps on the principal amount of the loan as included in the North Carolina law: " The principal amount of the loan does not exceed the lesser of (i) the conforming loan size limit for a single-family dwelling as established from time to time by the Federal National Mortgage Association, or (ii) three hundred thousand dollars ($300,000)."

Omit specific numbers in a rebuttable presumption for ability to repay loan
The rebuttable presumptions regarding a borrower's ability to repay a loan, which are included in most of the laws and legislation the subcommittee reviewed, were found to be helpful from a legal perspective, but the subcommittee members recommend exercising caution with the rebuttable presumptions because specific numbers can be misleading and result in unintended consequences.

Include "completion certification" requirement for Home Improvement Contracts
Although not essential to support an anti-predatory lending bill, the subcommittee members support the addition of a requirement for a "signed completion certificate" or an "affidavit of completion" to be presented to the lender before payment is made on a home improvement contract. The subcommittee members prefer the provisions included in the Georgia law, the AARP model bill, and Rep. Ney's bill (see attached matrix).

<u>Omit difficult credit counseling requirements that could slow down mortgage process for borrowers</u>
While the subcommittee supports any provision that will encourage credit counseling for consumers considering a high cost mortgage, the subcommittee is concerned with credit counseling requirements that could put a hardship on the borrower or slow down the borrowers' mortgage process, such as requiring a credit counseling course that is not conveniently available to the borrower.

While not essential to support an anti-predatory lending bill, the subcommittee members prefer a provision similar to the disclosures required in Senator Sarbanes' 2001 bill over the Georgia law requirement which calls for a "counseling certificate required from a 3rd party non-profit approved by HUD or state authority"

The Following is a good idea that credit unions should support:

<u>Lowering the "points and fees" threshold for a "high cost mortgage" to match the North Carolina law</u>
While not essential to support an anti-predatory lending bill, the subcommittee members agree with the North Carolina provision that lowers the points and fees threshold for determining when a home loan becomes a "high cost mortgage". Under existing law, a "high cost mortgage" is defined as one in which the points and fees reach "the greater of 8% of the total loan or $400". The North Carolina law has lowered this threshold to include loans where the points and fees "exceed 5% for loans of $20,000 or more; or the lesser of 8% of the loan or $1,000 if loan amount is less than $20,000."

# # #

COMPARISON OF ANTI-PREDATORY LENDING BILLS & LAWS

This table was prepared by CUNA, in cooperation with Dan Schline, North Carolina Credit Union League, Cindy Connelly, Georgia Credit Union League, Debbie Painter, Kentucky Credit Union League & AARP.

LAW/BILL	GEORGIA LAW	AARP'S MODEL ACT	SARBANES' BILL – 2002	NORTH CAROLINA LAW	KBA's 1ST DRAFT	NEY'S BILL - 2003	HOEPA
Preemption of State and/or local laws	Preemption of municipal and county ordinances that regulate terms of home loans or govern the eligibility of persons to do bus. with the muni. or county based on terms of home loans.	No preemption	No preemption	No preemption	Preemption of muni-cipalities and other political subdivisions.	Includes state and local preemption	States may enact addition protections for consumers.
Definition of a home loan to be covered by the law	Includes open-end credit plan where the prin. amount does not exceed the conforming loan size limit for single-family home; includes manufactured homes. Does not include: reverse mortgages, bridge loans for the initial construction of the dwelling, or a loan primarily for	Includes open-end credit plans and manufactured homes, does not include reverse mortgages	Includes residential mortgages and open-end credit plans, excludes reverse mortgages	Excludes open-end credit plans and reverse mortages; includes loans where the principal amount does not exceed the lesser of the conforming loan size for a single-family dwelling (FNMA) or less than $300,000	Excludes open-end credit and reverse mortgages, includes residential mortgages between $15,000 and $200,000. Does not apply to manu-factured homes. Excludes any US chartered entity engaging in secondary market mortgage transactions.	Excludes residential mortgages, reverse mortgages, and open-end credit plans	Excludes residential mortgages, reverse mortgages, and open-end credit plans

LAW/BILL	GEORGIA LAW	AARP'S MODEL ACT	SARBANES' BILL – 2002	NORTH CAROLINA LAW	KBA's 1ST DRAFT	NEY'S BILL - 2003	HOEPA
	business, ag. or commercial purposes.						
"Covered" home loan	1.Regardless of whether it's a residential HM, if APR exceeds: * 1st mort: the > of 4% pts above prime or 2% pts above 90 day standard com-mitment from Fannie or FHLMC; * jr.lien: the > or 5 ½ % above prime or 3 % above the 90 day standard commitment… 2. Pts & fees exceed 3%, excluding 2 bona fide discnt pts. 3. It is a HCM						
Definition of "high cost" loan	Follows HOEPA	More than 6% over Treas. (5 yr) for 1st lien; More than 8% over Treas. for jr. lien.	More than 6% over Treasury (comparable period) for 1st liens, More than 8% over Treas. for jr.liens.	Follows HOEPA	Same as HOEPA	For 1st mortg: if APR exceeds by more than 8% the Treasury yield for comparable period; For jr. lien: if APR exceeds by more than 10% Treasury yield for comp period	More than 8% over Treasury (comparable period) for 1st liens, More than 10% over Trea. for jr. liens

LAW/BILL	GEORGIA LAW	AARP'S MODEL ACT	SARBANES' BILL – 2002	NORTH CAROLINA LAW	KBA's 1ST DRAFT	NEY'S BILL - 2003	HOEPA
Points and Fees	HCM when *pts & fees exceed 5% for loans $20K and over; or * the lesser of 8% of the total loan amt or $1,000 if loan is less than $20K * can exclude 2 bona fide discnt pts.	HCM when *pts & fees exceed 3% for loans over $30K; * 6% for loans less than $30,000 *Can exclude 2 bona fide discount pts. *total loan amt =principal loan amount – financed pts & fees.	HCM when pts and fees exceed 5% of total loan amount or $1,000, excluding not more than 2 bona fide discount pts.	HCM when: (1) pts & fees exceed 5% for loan of $20K or more; or the lesser of 8% of loan or $1,000 if loan amt is < $20K, excluding: * 2 bona fide dscnt pts if interest rate not more than 1% above 90 day standard commitmt., *up to 1 bona fide discnt pt. if interest rate not more than 2% above 90 day standard …. * prepayment fees and penalties allowed under loan docs that do not exceed 1% of prepaid amt.	No threshold. Lender may not w/i the 1st yr. charge pts and fees in connection with a HCM if the proceeds are used to refin. an existing HCM. Lender may not charge a borrower pts and fees in addition to those allowed by Reg Z if the proceeds of the HM are used to refi. an existing HCM by same lender.	HCM when *pts and fees exceed 6% of total loan for loans over $30K–; *pts and fees exceed 7% for loans $30K or less. *may exclude no more than 2 bona fide discount points	HCM when pts. and fees exceed the greater of 8% of the total loan, or $400 – to be adjusted annually
Financing of Points and fees	–	No financing of points & fees	Prohibits if the amt is in excess of the greater of 3% of the total loan amount or $600. Prohibits financing any prepayment penalty in connection with a refinance if creditor is same creditor/affil. for loan being refinanced. Prohibits financing any points, fees, or charges if the high-cost mortg is to refinance an existing high-cost loan with the same creditor/affiliate.	No financing prepayment fees or penalties; points and fees; or any charges to 3rd parties. Cannot charge any points and fees if proceeds of the HCM are used to refinance an existing HCM by same creditor.	If the HCM is to refinance another HCM by the same lender, may not finance pts & fees which in the aggregate are in excess of 4% of the total amt.	Permitted with a required disclosure that says that financing points and fees is "not legally required".	**N/A**

LAW/BILL	GEORGIA LAW	AARP'S MODEL ACT	SARBANES' BILL – 2002	NORTH CAROLINA LAW	KBA's 1ST DRAFT	NEY'S BILL - 2003	HOEPA
Prohibitions for ALL Home Loans	*Financing single prem. credit insur. * Flipping * Recommending default * Late fees * Fee for acct balance	*Financing single prem. credit insur. *Flipping *Recommending default *Late fees in excess of 4% *Acceleration of debt *Fee for statement of balance due		*Financing single prem. credit insur. *Flipping *Recommending default			**N/A**
Prohibitions on High Cost Home Loans							
Single Premium Credit Insur. (SPCI)	Prohibits financing credit insurance, debt cancellation and debt suspension agreements. Premiums calculated and paid on monthly basis permitted. Applies to all loans	Prohibits financing credit insurance, debt cancellation and debt suspension agreements. Premiums calculated and paid on monthly basis permitted. Applies to all loans.	Prohibits, whether paid directly or financed,the advanced collection of SPCI, as well as debt cancellation or suspension agreements Does not prohibit collection of premiums payments ca-culated and pd on a regular monthly basis if the insur. transaction is conducted separately and the insur can be cancelled.	Prohibits financing credit life/disability, unemployment insur. or any other life or health insur.. Premiums calculated and paid on monthly basis permitted.	(Prohibition to be added in final draft)	Prohibits the offer or sale of any insurance policy on a single premium basis for credit insurance to cover death, illness, accident, disability, or unemployment.	**N/A**

LAW/BILL	GEORGIA LAW	AARP'S MODEL ACT	SARBANES' BILL – 2002	NORTH CAROLINA LAW	KBA's 1ST DRAFT	NEY'S BILL - 2003	HOEPA
"Flipping"	No flipping: Define: *when creditor makes a "covered" home loan to refinance a home loan initiated less than 5 yrs ago and new loan has no reasonable, tangible net benefit. * when a "covered" HM refinances a home loan initiated less than 5 yrs that is subsidized or guaranteed by agency, nonprofit etc. and has special terms for borrower Applies to all loans.	No flipping. Define: A refi where new loan has no reasonable net benefit to B. (if it will take over 4 yrs to recoup pts and fees; if refis special low cost mtg and B loses 1 or more benefits.)	N/A	No flipping: : A refi where new loan has no reasonable net tangible benefit to Borrowers.	Lender may not refi. a low interest or zero interest loan made by a governmental or non-profit lender with a high-cost loan. Low interest loan defined as loan with interest rate 2% below current yield on US Treasury securities with comparable maturities.	May not refi a HCM with another HCM within the 1st yr unless the finance charge for the balance of the existing HCM exceeds the finance charge for the new HCM for an amt greater than the amt of the fee and charges imposed by the creditor for the new HCM. Mortgage broker may not arrange for the refi. of one HCM with another HCM w/I the 1st yr. HCM cannot refinance a low interest loan made by govt. agency, GSE or non profit wi 10-yr period, w/o a written consent of the holder of the loan, or certification from HUD agency that credit counseling has been obtained.	**N/A**

LAW/BILL	GEORGIA LAW	AARP'S MODEL ACT	SARBANES' BILL – 2002	NORTH CAROLINA LAW	KBA's 1ST DRAFT	NEY'S BILL - 2003	HOEPA
Late Fees	No late fee unless: loan docs authorize, the paymt is 10 days past due, the fee does not exceed 5% of the late paymnt, only one fee per late payment, cannot affect subsequent payments.	No late fees in excess of 4% of amt past due; subsequent payments cannot be made late because portion allocated to pay prior late charge	N/A	N/A	N/A	N/A	N/A
Access to "account balance" information	No fee for statemnt balance; except can charge up to $10 when sent by fax or w/i 60 days of previous request. Shall be provided w/i 5 bus. days.	No fee for statement of balance due. Delivered in reasonable time, not later than 7 business days. Applies to all loans.	N/A	N/A	N/A	No fee for "balance due" statement unless fax, or courier, used or more than 4 requests in one year. Delivery in reasonable time no later than 5 business days.	N/A
Prepayment penalty	Permitted w/i 1st 24 months. Cannot exceed 2% in 1st 12 months, or 1% in second 12 months.	Limited to 2% in 1st 12 months and 1% in 2nd 12 months.	Prepayment penalty permitted w/i 1st 24 months; No prepayment if more than 3% of pts & fees financed	No prepayment fees for loans of $150K or less. This is preempted by federal law. (Law for all home loans)	Prepaymt penalty allowed w/i 1st 36 months; Limited to 3% for 1st yr.; 2% for 2nd yr. ; 1% for 3rd yr.	Prepayment penalty permitted w/i 1st 4 years. if B's monthly debt, including mort. is < 50% of income	Prepayment penalty permitted w/i 1st 5 yrs, if B's monthly debt, including mort. is < 50% of income
Balloon payments	No balloon payments, except to accommodate seasonal/ irregular income of borrower.	No balloon payments, except to accommodate seasonal/ irregular income of borrower.	All balloon payments prohibited. HCM	No balloon payments, except to accommodate seasonal/ irregular income of borrower.	No balloon payments, except to accommodate seasonal/ irregular income of borrower.	**Adds** exceptions to HOEPA for seasonal/irregular income; bridge loan made in connection with acquisition or construction and	No balloon payment in loans with terms of less than 5 years (Reg Z: does not apply to "bridge" loans) HCM

LAW/BILL	GEORGIA LAW	AARP'S MODEL ACT	SARBANES' BILL – 2002	NORTH CAROLINA LAW	KBA's 1ST DRAFT	NEY'S BILL - 2003	HOEPA
						Adds a notice requirement that discloses the balloon term, its amount and that this term is not required.	
Negative Amortization	Prohibits negative amortization	Prohibits negative amortization.	Prohibits negative amortization	Prohibits negative amortization.	Prohibits negative amortization	Prohibits, **except** where neg. amort. results from periods of temporary forbearance allowed by creditors.	Prohibits negative amortization.
Evasion / structuring	Prohibits bad faith attempts to divide loans into separate parts, or structuring them as open-end loans to evade this provision	Prohibits: Creditor may not in bad faith divide loan into separate parts to evade or engage in any other subterfuge.	Prohibits: Adds to HOEPA: Prohibition on purposeful evasion of requirements for HCM by entering into reciprocal arrangements, dividing loan transaction into separate parts, structuring consumer credit transaction to avoid requirements. Also, may not take any action that the Board determines, by regulation, to constitute a bad faith effort to evade or circumvent any requirement of the section regarding a	Prohibits bad faith attempts to divide loans into separate parts, or structuring them as open-end loans, or any other subterfuge to evade this provision.	Prohibits bad faith attempts to divide loans into separate parts, or structuring them as open-end loans, or any other subterfuge to evade this provision	Prohibits: Adds to HOEPA: Prohibition on purposeful evasion of requirements for HCM by entering in to reciprocal agreements, dividing loan transaction into separate parts, structuring loan to avoid requirements. The board shall prescribe such regulations necessary to enforce these	Prohibits structuring a loan as an open-end credit plan to evade HOEPA. Creditor may not engage in a pattern or practice of arranging for refinance of its own loans by affiliated or unaffiliated creditors or modify a loan agreement and

LAW/BILL	GEORGIA LAW	AARP'S MODEL ACT	SARBANES' BILL – 2002	NORTH CAROLINA LAW	KBA's 1ST DRAFT	NEY'S BILL - 2003	HOEPA
			consumer credit transaction. The board shall prescribe appropriate regulations to prevent such actions.			requirements.	charge a fee to evade anti-flipping provision.
Encouraging Default	Prohibits encouraging or recommending default on existing loan or other debt to be refinanced by new loan. Applies to all loans	Prohibits encouraging or recommending default of previous obligations. Applies to all loans	Prohibits any statement, act, or omission by creditor that has the effect of encouraging or recommending default of an existing loan.	Prohibits encouraging or recommending default on existing loan or other debt to be financed by new loan. Applies to all loans		No encouraging or recommending default on existing loan or other debt to be financed by new loan. Applies to all loans	**N/A**
Acceleration of Debt	Prohibits terms allowing acceleration of debt at creditor's sole discretion. Does not apply when repayment of the loan has been accelerated due to borrower's failure to abide by material term s of loan..	Prohibits terms allowing acceleration of indebtedness, or call provision, at creditor's sole discretion. (ALL LOANS)	Prohibits terms allowing acceleration of debt at creditor's sole discretion. Does not apply when repayment of the loan has been accelerated as a result of a bona fide default.	Prohibits terms allowing acceleration of debt at creditor's sole discretion. Does not apply when acceleration by default or a due-on-sale clause; or other provision of the loan docs related to the payment schedule.	Prohibits terms allowing acceleration of debt at creditor's sole discretion. Does not apply when acceleration by default or a due-on-sale clause; or other provision of the loan docs related to the payment schedule.	Prohibits terms allowing acceleration of debt at creditor's sole discretion. Does not apply when acceleration by default or a due-on-sale clause; or due to any act omission by the consumer that adversely affects creditor's sec-urity interest or any rights in such interest.	No demand feature unless (1) fraud or material misrep. by B. (2) fails to meet repay terms, (3) action or inaction that effects the creditor's security or any right of the creditor in such security.

LAW/BILL	GEORGIA LAW	AARP'S MODEL ACT	SARBANES' BILL – 2002	NORTH CAROLINA LAW	KBA's 1ST DRAFT	NEY'S BILL - 2003	HOEPA
Penalty interest rates	Prohibits increase of interest rate upon default. Does not apply to variable rates consistent with loan docs.	Prohibits increase of interest rate upon default.	**N/A**	Prohibits increase of interest rate upon default. Does not apply to variable rates consistent with loan docs, provided not triggered by default.		Prohibits increase in interest rate upon default, except due to change in index for variable rate mtg.	Prohibits increase in interest rate upon default.
Excessive Advance Payments	Prohibits the consol-idation of more than 2 periodic payments paid in advance from the loan proceeds.	Prohibits financing more than two payments paid in advance from loan proceeds.	**N/A**	Prohibits the consol-idation of more than 2 periodic payments paid in advance from the loan proceeds	Prohibits financing more than two payments paid in advance from loan proceeds	Prohibits prepayment of periodic payment of interest or principle from proceeds.	Prohibits financing more than two payments paid in advance from loan proceeds.
Modification and deferral fees	Prohibits modification and deferral fees.	Prohibits modification and deferral fees.	Prohibits modif. and deferral fees, **unless** fee is in connection with an action that provides a material benefit to the consumer and the amount of the fee does not exceed (i) an amount equal to 0.5% of the total loan amount; or (ii) in excess of $300 when the total loan amount does not exceed $60,000.	Prohibits modification and deferral fees.	Permitted where fees are less than ½ of any fees that would be charged to refinance or where borrower is in default and it is in borrower's best interest.	Prohibits modif. and deferral fees **unless** modification results in a lower APR and amt of fee must be comparable to fees imposed for similar consumer credit transactions that are secured by principal dwelling and are not residential mort. transactions or HCM.	**N/A**

LAW/BILL	GEORGIA LAW	AARP'S MODEL ACT	SARBANES' BILL – 2002	NORTH CAROLINA LAW	KBA's 1ST DRAFT	NEY'S BILL - 2003	HOEPA
Mandatory Arbitration	Finds any requirement of a forum that is less convenient, more costly, or more dilatory for the resolution of a claim or dispute than a judicial forum to be unconscionable and void.	Prohibits mandatory arbitration for HCM	Prohibits mandatory arbitration , but does not limit the consumer's right to agree to arbitration or any other type of nonjudicial procedure at any time after a dispute or claim arises. No mort. provision shall be applied or interpreted to bar a consumer from bringing an action in court for damages or relief in connection with any violation.	N/A	N/A	Prohibits oppressive, unfair or unconscionable mandatory arbitrations clauses that are substantially in derogation of the rights of consumers. Provides a safe harbor for provisions that (a) establish venue in Fed. Dist. where property is located; (b) complies with standards of nationally recognized arbit. org.; and (c) creditor bears all costs for first 2 days of arbitration.	N/A
Ability to Repay	Creditor must believe based on current and expected inc., current obligations, employment status and other fin. resources, other than borrower's equity in	No lending w/o regard to ability to repay. Creates rebuttable presumption of ability if meet certain criteria applicable to VA loans. [The VA regs allow for a debt to income ratio of 41% and require that the borrowers have residual income to pay	HOEPA + *Requires case-by-case assessment of ability to repay. *1 or more resident obligors must be able to make pay-ments bases on current and expected income, current obligations, employment	Creditor must believe that borrower can make scheduled payments based on current and expected inc., current obligations, employment status and other fin. resources, other than borrower's equity in	Lender must consider ability to repay. Presumption of repayment ability exists where borrower's debts to not exceed 50% of gross monthly income, but no	HOEPA + *Adds presumption of ability to repay if consumer's total monthly debts, including this loan, do not exceed 53% of monthly gross income, which must	Prohibits pattern of practice of lending w/o regard to ability to pay, including consumers' current and expected income, current

LAW/BILL	GEORGIA LAW	AARP'S MODEL ACT	SARBANES' BILL – 2002	NORTH CAROLINA LAW	KBA's 1ST DRAFT	NEY'S BILL - 2003	HOEPA
	collateral. A rebuttable presumption if borrower's total monthly debts, including loan payments., do not exceed 50% of borrower's monthly gross income as verified.	monthly living expenses beyond shelter.]	status, w/o taking equity into account. * Adds requirement that creditor independently verify info.	collateral. A rebuttable presumption if borrower's total monthly debts, including loan paymt, do not exceed 50% of monthly gross income as verified.	presumption of inability to repay if debts exceed 50% of income.	be verified. *presumption not applicable in case of balloon payments.	obligations, and employment
Home Improvement Contracts	Payment to contractor only if affidavit of completion presented, and instrument is payable to borrower or jointly to borrower and contractor or 3rd party escrow agent as agreed upon in a written signed contract.	Payment to contractor only if have signed completion certi. and instrument is payable to borrower or jointly to borrower and contractor or 3rd party escrow agent Adds liability for assignee or holder of one of these HCM. Liable for all affirmative claims and defenses against seller, home improvement contract, broker or creditor	Adds liability for assignee or holder of one of these HCM. Liable for all affirmative claims and defenses against seller, home improvement contract, broker or creditor.	Lender can only pay contractor by: payment to borrower, check jointly to borrower and contractor or through an escrow agent as agreed upon in written, signed contract.	Lender can only pay contractor by: payment to borrower, check jointly to borrower and contractor or through an escrow agent	Creditor may not use proceeds of HCM for final payment of home improvemt contract w/o proof that contractor has fully performed contract. Proof req'd is satisfied by signed statement by consumer that contractor has fully performed the contract. Adds liability for assignee or holder of one of these HCM. Liable for all affirmative claims and defenses	

LAW/BILL	GEORGIA LAW	AARP'S MODEL ACT	SARBANES' BILL – 2002	NORTH CAROLINA LAW	KBA's 1ST DRAFT	NEY'S BILL - 2003	HOEPA
						against seller, home improvement contract, broker or creditor	
Credit Counseling	Counseling certificate required from 3rd party non profit approved by HUD or state authority. No creditor, servicer or its institution shall be required to contribute to the funding of a non-profit credit counseling org.	Counseling required before creditor can make a HCM.	Before making HCM, creditor must provide: *all warnings and disclosures re: risks; *A separate writing recommending credit counseling; and *A written list of counseling services with addresses and numbers *Failure to provide current and complete list is a violation	Borrower must have certificate from state agency approved counselor that has advised the borrower on the loan transaction.	Borrower must receive counseling certification from agency approved by HUD or state authority, but the borrower may waive this requirement.	N/A	N/A
Credit Reporting	-	N/A	Adds to Fair Credit Reporting Act: Each creditor, and each successor to a creditor, who enters into a high-cost loan shall report the complete payment history, favorable and unfavorable , with respect to the transaction to a national consumer reporting agency at least quarterly.	N/A	--	For HCM, creditor, assignee, or servicer shall furnish once a quarter, to a consumer reporting agency as defined by FCRA, the complete payment information relating to HCM; Any offer by a creditor of terms that would be defined as HCM	N/A

LAW/BILL	GEORGIA LAW	AARP'S MODEL ACT	SARBANES' BILL – 2002	NORTH CAROLINA LAW	KBA's 1ST DRAFT	NEY'S BILL - 2003	HOEPA
						shall be treated as an adverse action with respect to the FCRA.	
Borrower's Right to Cure	Right to Cure – nullifies acceleration of obligation. No fees for exercising right to cure in 1st 30 days, or fees over $100 after 1st 30 days.; after forecl. only reasonable atty fees. If default cured prior to forecl., lender cannot initiate foreclosure, if cured after initiation – must terminate forecl. Before forecl.initiated must send notice of right to cure the default.	• Right to Reinstate • Grounds for Reinstatement • No fees for exercising right to cure in 1st 30 days, or fees over $100 pre-forecl.; after forecl. only reasonable atty fees. • If default cured prior to forecl., lender shall not start forecl.	N/A	N/A	N/A	N/A	N/A

DISCLOSURES	
GEORGIA'S LAW	N/A
AARP'S MODEL LAW	N/A
SARBANES' 2002 BILL	(A) and (B) from HOEPA, and: "(C) 'The interest rate on this loan is much higher than most people pay. This means the chance that you will lose your home is much higher if you do not make all payments under the loan.'. '(D) 'You may be able to get a loan with a much lower interest rate. Before you sign any papers, you have the right to go see a housing or consumer credit counseling agency, as well as to consult other lenders to find ways to get a cheaper loan.'. '(E) 'If you are taking out this loan to repay other loans, look to see how many months it will take to pay for this loan and what the total amount is that you will have to pay before this loan is repaid. Even though the total amount you will have to pay each month for this loan may be less than the total amount you are paying each month for those other loans, you may have to pay on this loan for many more months than those other loans which will cost you more money in the end.'.
NORTH CAROLINA'S LAW	N/A
KBA'S 1ST DRAFT	Similar to HOEPA warnings, also advises borrower to shop around, seek financial counseling.
NEY'S 2003 BILL	(A) and (B) from HOEPA, and: "(3) The rate of interest and the amount of fees you pay on a loan may vary depending on which lender or broker you select. (4) The timing and amount of payments on debts you already are carrying contribute to the credit rating that is used to determine whether you may get a new loan and how much you will pay for that new loan. You should NOT accept any advice to ignore or delay making any payments on loans you already have, even if those loans will be paid off with the new loan. (5) You may get into serious financial difficulties if [you] use this loan to pay off old debts and then run up other new debts."
HOEPA	(A) "You are not required to complete this agreement merely because you have received these disclosures or have signed a loan application." (B) "If you obtain this loan, the lender will have a mortgage on your home. You could lose your home, and any money you have put into it, if you do not meet your obligations under the loan."

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Sept 23, 2002

Review:

"North Carolina's Subprime Home Loan Market After Predatory Lending Reform,"

a report from the Center for Responsible Lending

A North Carolina-based nonprofit advocacy group, the Center for Responsible Lending (CRL), has released a study claiming to show that North Carolina's 1999 anti-predatory lending law saved consumers $100 million on home mortgages originated during the year 2000.[1] The authors evaluated data reported under the Home Mortgage Disclosure Act (HMDA) from 1998- 2000 and concluded that subprime mortgage lending continued to "thrive" in North Carolina after passage of the statute and low-income borrowers continued "to have access to a wide range of choices when selecting a home loan."

North Carolina Governor Michael Easley and Attorney General Roy Cooper hailed the study in a joint press conference in Raleigh. Easley remarked that if other states followed North Carolina's lead in clamping down on predatory lending practices, consumers could save billions of dollars, nationwide. Cooper said the law hasn't hurt the availability of subprime credit in the state, despite the claim of financial services industry lobbyists during the legislative debate in the state's General Assembly.

A careful review of the CRL report reveals quite a different story. The evidence presented does not support, and often contradicts, the report's conclusions. In fact, the data presented are consistent with a decline in subprime lending and a reduction in the availability of mortgage credit to low income borrowers in North Carolina following enactment of the anti-predatory law, despite the author's claims to the contrary. Moreover, the calculations of the dollar value of consumer benefits are largely asserted, and do not derive from the same database used to evaluate the effects of the statute on loan volume. In short, no convincing evidence is offered to show either a reduction in "predatory lending" or net benefits to consumers from restrictions on credit terms.

The following sections take the study's three "key findings" and evaluate the evidence offered by CRL to determine if the facts support the conclusions.

[1] Keith Ernst, John Farris, and Eric Stein, "North Carolina's Subprime Home Loan Market After Predatory Lending Reform," Center for Responsible Lending, Durham, NC, August 13, 2002.

CRL Study Methodology and Data

At the outset it should be noted that all of CRL's conclusions regarding the volume and composition of subprime mortgage lending in North Carolina are based on HMDA reports filed for 1998-2000. Even though this database covers 28 million loans ($3.3 trillion) originated across the U.S. over the three-year period, housing market researchers recognize that HMDA data have serious weaknesses when used to analyze ***subprime*** lending. Since CRL relies exclusively on HMDA data in drawing its conclusions it is helpful to review the limitations of the data.

First, HMDA data do not identify a particular mortgage loan as subprime. The Department of Housing and Urban Development (HUD) annually produces a list of lenders believed to be predominately subprime lenders. Studies that examine subprime lending using HMDA data must assume that loans made by lenders on the HUD subprime list are actually subprime loans. However, many lenders designated as subprime lenders also make prime loans. Conversely, many lenders who are not considered predominately subprime lenders nevertheless make large numbers of subprime loans. These loans would be overlooked in any subprime analysis based on the HUD list.

Finally, there are many institutions that are not required to report under HMDA, and their lending activity is not reflected in the HMDA data at all. Currently, a non-depository institution must report under HMDA only if its annual lending for home purchase and refinancing equals 10 percent or more of the dollar value of its loan originations (mortgage and non-mortgage). Many non-depository institutions (e.g., consumer finance companies) have long specialized in making loans of all kinds to "subprime" borrowers. Subprime mortgage loan originations from many of these companies are also missing from the HMDA database.

As a consequence, use of the HUD subprime list in conjunction with the HMDA data produces, at best, a very rough approximation of subprime mortgage lending. Of course, researchers use the HUD/HMDA approximation of subprime lending because there are few alternative sources of data on subprime mortgage activity. Nevertheless, any study that attempts to analyze changes in subprime origination volume using the HUD/HMDA data should temper its findings with a full disclosure of the limitations of the data. No such disclaimer appears in the CRL study, thereby encouraging the reader to place more confidence in the study's conclusions than is warranted.

Moreover, the HMDA data do not include any information on loan pricing or borrower risk characteristics (other than income). Consequently, the HUD/HMDA subprime data cannot be used to identify changes in underwriting standards, e.g., tightening of credit to higher risk borrowers. Of course, such changes are precisely the adjustments that subprime lenders would likely make when confronted with a new statute that imposes restrictions on high-cost loans.

CRL Finding #1 Subprime Lending Continues to Thrive in North Carolina

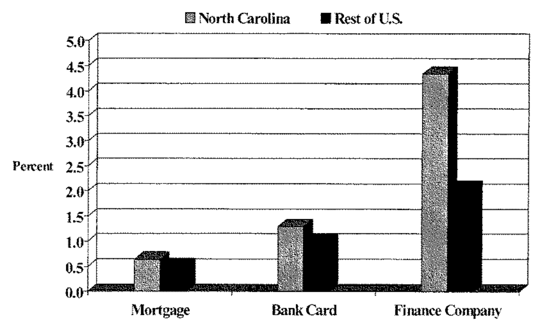
CRL used the HMDA data to identify several measures of subprime loan activity in North Carolina, relative to the rest of the United States. They employed a comparative approach, and inferred a continued "thriving" subprime market because subprime activity per capita was higher in North Carolina, relative to the U.S. average, in the first full year following the July 1, 1999 passage of the state's anti-predatory lending statute.

The HUD/HMDA data show that "home loan borrowers in North Carolina were 20% more likely than borrowers in the rest of the nation to receive a subprime loan in 2000." In addition, North Carolina had 15% more subprime loans per capita than the rest of the nation in 2000." These observations apparently settle the issue according to CRL.

Of course, a higher incidence of subprime activity in North Carolina relative to the U.S. average during 2000 tells us nothing about the impact of the North Carolina statute that was passed the previous year. There is ample evidence that the size of the subprime market in North Carolina is substantially larger than the U.S. average. For example, impaired credit history is a common characteristic of the subprime borrower. Figure 1 illustrates that the percent of borrowers who are seriously delinquent (90+ days past due) is much higher in North Carolina than the U.S. median across all types of loans.

Figure 1

Percent of Borrowers 90+ Days Past Due, North Carolina vs. the U.S. Median
Second quarter, 2000



Source: TrenData, Trans Union LLC.

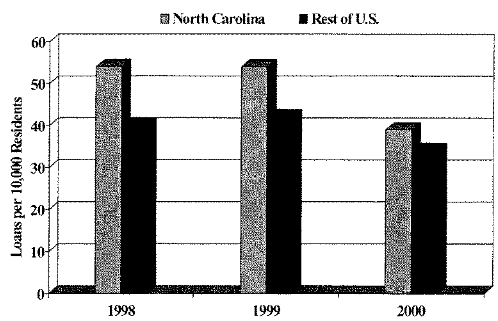
With a substantially higher proportion of its borrower population having impaired credit histories, *North Carolina could continue to exhibit a higher-than-average incidence of subprime lending even if the 1999 statute caused creditors to decrease the supply of subprime loans.* Consequently, the question the CRL researchers should have asked is whether subprime lending in North Carolina fell, relative to the U.S. average, following passage of the statute.

Figures 2 and 3 display the data cited in the CRL report and reveal that both of their measures of subprime activity in North Carolina relative to the U.S. did decline. In 1998, the number of subprime loans per 10,000 residents was 35% higher in North Carolina than the U.S. average; by 2000, it was only 15% higher (Figure 2). Similarly, the proportion of all mortgage loans originated in North Carolina that were subprime was 33% higher than the U.S. average in 1998; by 2000 it was only 18% higher (Figure 3).

Neither of the trends in the two figures support a conclusion of a "thriving" subprime market in North Carolina. In particular, Figure 2 shows that while subprime originations appear to have been declining nationwide during 2000, the decline was larger in North Carolina.[2]

Figure 2

Subprime Mortgage Loans per 10,000 Residents, North Carolina vs. the U.S. Average

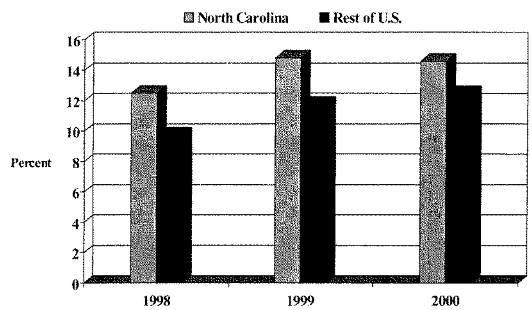


Source: HMDA.

[2] Of course, all of these conclusions must be tempered with the knowledge that the HUD/HMDA subprime database provides an incomplete picture of all subprime activity.

Figure 3

Subprime Loans as a Percent of All Mortgage Loans, North Carolina vs. the U.S. Average



Source: HMDA.

CRL Finding #2 Choice remains unfettered: North Carolina borrowers continue to have a wide range of choices when selecting a home loan.

Evidence offered to support this conclusion is the observation that "every lender (21 in all) with more than one percent of the 1999 North Carolina subprime market that reported new lending anywhere in the United States reported originating new loans in North Carolina in 2000."[3] It is true that all 21 lenders remained active in the North Carolina market, but this tells us little about the borrowers to whom they were lending.

On this point the shortcomings of the HUD/HMDA data are most apparent. As discussed above, not all loans made by the HUD/HMDA subprime lenders are subprime. There is simply no way to tell from the HMDA data the percentage of originations during 2000 that were made by these 21 lenders to subprime borrowers. It is entirely possible that these lenders continued to make mortgage loans in North Carolina but shifted their lending mix toward a higher proportion of prime loans and smaller proportion of subprime loans. Consequently, a wide range of choices may have continued to be available to borrowers in general, but subprime borrowers may have found that some of these lenders no longer welcomed their business. The HMDA provide no information one way or the other.

Further, because the HMDA data do not contain information on borrower risk characteristics, the data can't be used to detect shifts in underwriting guidelines that

[3] Ernst, Farris, and Stein, 2002, p 5.

might have been triggered by the 1999 statute. For example, an economic model of a lender's reaction to higher costs of servicing higher-risk borrowers (consequent to passage of the 1999 North Carolina statute) would predict that lenders would reduce the supply of loans to higher-risk borrowers. A lender could remain active in the subprime market, but set higher acceptance standards, so that borrowers with higher FICO risk scores would be denied loans, even though borrowers with the same risk profile were accepted prior to the 1999 statute. Again, the HMDA data can't be used to confirm or refute this prediction.

CRL Finding #3: Reductions in predatory lending saved North Carolina homeowners more than $100 million in 2000.

The CRL authors calculate two components of the savings to North Carolina borrowers from a reduction in predatory lending. The 1999 statute banned some loan contractual features, most notably the sale of single-premium credit insurance on all loans and prepayment penalties on loans smaller than $150,000. In addition, the act may have prevented some predatory loans from being made at all, presumably saving the would-be victims from excessive charges. The authors do not provide convincing estimates of net savings for either component.

In explaining their first two major findings, the CRL authors failed to note that the HMDA data signal a decline in subprime lending in North Carolina during 2000. Possibly this failure was because such an observation did not support their claim of a healthy subprime market in North Carolina. However, to be able to show savings to North Carolina borrowers resulting from a decline in predatory lending, they need to observe a reduction in subprime loans. Only in support of Finding #3 do they acknowledge the decline in originations per capita. By comparing ratios of North Carolina subprime borrowing relative to the U.S. before and after the 1999 statute, the authors concluded "the data show that the North Carolina subprime market declined 6.6% beyond that predicted solely by the relative decline in other markets."[4]

The next step in the authors' calculation of borrower savings is pure assertion. The authors state "this 6.6% net real decline is consistent with a significant reduction in predatory lending."[5] They translate the 6.6% reduction into a calculated decline of 2,700 loans, all deemed predatory in the subsequent calculations of dollar savings. They provide no further evidence in support of this conclusion. To repeat, ***the authors assert that all of the reduction in subprime lending observed in North Carolina in the year following passage of the 1999 statute was a decline in predatory lending.*** Of course, this assertion totally ignores a variety of other possibilities, including the possibility that subprime lenders may have raised underwriting standards so that some previously creditworthy borrowers (possibly 2,700 such borrowers) were denied loans.

As for the calculated dollar savings from banned loan features, these do not hold up well under closer scrutiny. None of the data used to support the savings from banned

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[4] Ernst, Farris and Stein (2002) p 10.
[5] Ernst, Farris and Stein (2002) p 11.

contractual features derives from the HMDA data. Consequently, the calculations are not based on a careful study of the loans on which the previous conclusions are based.

If they do not inspect a representative sample of loans (originated in North Carolina or elsewhere), then how do the authors calculate savings to borrowers? One example from their report illustrates their methodology.

Savings from the ban on Single Premium Credit Insurance: The 1999 North Carolina statute bans the sale of single-premium credit insurance (SPCI) on ***all*** mortgage loans (prime and subprime). However, the authors focus only on the resulting savings to the borrowers holding the 31,500 subprime loans made in North Carolina during 2000. Based on conversations with credit insurance industry representatives regarding SPCI product penetration rates and average premiums, the authors projected that 20% of the 31,500 subprime loans originated in North Carolina during 2000 (i.e., 6,300 loans) would have had SPCI in the absence of the 1999 statute. Further, they estimated a total premium cost of $6,600 per loan with SPCI. Multiplying $6,600 per loan by 6,300 loans yields a savings of $41.6 million to North Carolina borrowers.

Set aside for the moment the issue of whether the assumed penetration rate and premium cost per loan are reasonable estimates. The author's calculation makes a fundamental and unstated assumption. *For the calculation to be correct, all of the premium paid for SPCI must be a waste – no net benefit or value to the borrower whatsoever.* In essence, the authors assume that any payment for credit insurance is equivalent to paying something for nothing. Of course, this assumption is inconsistent with the observation that tens of millions of borrowers have voluntarily purchased the single-premium credit insurance policies that are in effect across many types of consumer loans in the U.S. It is also contradicted by the observation that borrowers who are offered credit insurance on a monthly premium basis continue to purchase the product.

The ban on Single Premium Credit Insurance provides nearly 42% of the authors' projected savings to North Carolina borrowers from reducing predatory lending. The remaining savings derive from applying similar methods to estimate incidence and dollar cost of 1) flipped refinances with "no net benefit to the borrower", 2) cutting "excessive" fees, 3) prohibiting prepayment penalties on loans < $150,000.[6] Closer inspection of each of these calculations reveals a pattern of basing dollar savings estimates on incidence rates inferred from small "convenience" samples. Even more troubling from a methodological standpoint, the authors repeatedly rely on the (unstated) assertion that a ban or limitation placed on a particular contractual feature triggers no additional cost or loss of benefit to the borrower.

Because their methods do not rely on sound statistical procedures, there is little or no scientific justification for the authors' calculations. In the end, the estimates of consumer savings are merely assertions.

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[6] For a more detailed discussion of the source of the estimates underlying the dollar savings calculations see Eric Stein, "Quantifying the Economic Cost of Predatory Lending," Center for Responsible Lending, Durham, NC, October 30, 2001.

RESPRO®
Real Estate Services Providers Council, Inc.

November 5, 2003

The Honorable Robert Ney
Chairman
Subcommittee on Housing and Community Opportunity
Committee on Financial Services
2438 Rayburn House Office Building
Washington, D.C. 20515

Dear Chairman Ney:

On behalf of the Real Estate Services Providers Council (RESPRO®), I would like to comment for the record on the November 5, 2003 hearing entitled, "Protecting Homeowners: Preventing Abusive Lending While Preserving Access to Credit".

I wish to begin by congratulating you for holding this hearing. Given the proliferation of state and local laws addressing predatory lending that have proliferated the past couple years, it is essential that Congress exercise its responsibilities to ensure that the national mortgage market is not being impaired by these laws.

As you know, RESPRO® is a national non-profit trade association of affiliated settlement service businesses from all segments of the industry. Our membership includes mortgage lenders, mortgage brokers, real estate companies, homebuilders, and title underwriters and agents (see attached Membership List).

The majority of our members offer mortgage loans, either directly or through wholly-owned subsidiaries or joint ventures partners. The common interest of RESPRO® members is their ability to cost-efficiently offer mortgage loans to consumers in a variety of affiliated business structures with other settlement service providers. Therefore, our comments about this debate relate solely to that interest.

As you know, the 1994 Home Owners Equity Protection Act (HOEPA) places loan term restrictions and disclosure requirements on 'high cost' mortgages with an interest rate of more than 10% above the Treasury rate or mortgages with points and fees of more than 8% of the loan amount.

Unfortunately, HOEPA currently discriminates against affiliated businesses by counting 'points and fees' paid by the consumer to affiliated settlement services providers, but not unaffiliated third parties, towards the threshold.

Not only is there any legislative history nor known rational basis for this discriminatory provision in HOEPA, it also has the effect of discriminating against businesses that have consistently been proven to potentially increase competition and lower costs for home-buyers and owners.

In 1994 RESPRO® commissioned a study by Lexecon, Inc., a national economic consulting firm, which clearly shows the benefits of affiliated businesses. The firm analyzed the title and closing costs of over 1000 home purchase transactions—affiliated and unaffiliated—during a one-week period in September 1994. The study concluded that title services for transactions involving affiliated title/closing businesses not only are competitive with those provided by unaffiliated title/closing companies, but actually result in a two percent (2%) savings.

In a Regulatory Analysis accompanying a 1996 final Real Estate Settlement Procedures Act (RESPA) regulation, the Department of Housing and Urban Development (HUD) stated, "[T]here is some reason to expect that referrals among affiliated firms may reduce costs to businesses and consumers. Business may benefit from lower marketing costs and the ability to share information on the home purchase or refinancing among settlement service providers. In the long run, any cost savings should be passed on to consumers in most cases. Consumers may benefit additionally from reduced shopping time and related hassles."

Not only does the current HOEPA law restrict loans offered by providers who potentially offer consumers lower cost loans, but it totally ignores whether the fees paid in any particular loan transaction are reasonable. For example, a $1,000 charge for title insurance and $300 charge for an appraisal in a particular loan transaction by an unaffiliated settlement service provider would not be counted as 'points and fees', while similar or even lower charges by an affiliated settlement service provider (e.g., $750 for title insurance and $250 for an appraisal) would count as 'points and fees'.

I am pleased to note that your bill, H.R. 833, corrects this invidious discrimination. Only by treating all mortgage lenders fairly, regardless of their corporate structure, will we be able to truly have a thriving and vibrant national mortgage market.

I recognize this is the first in a probable series of hearings on this issue. As this debate continues to unfold, I look forward to working with you on this issue.

Again, thank you for your leadership and for beginning this important, and long overdue, national dialogue. If you have any questions or would like to obtain additional background information, please feel free to contact me at 202-408-7038 or to e-mail me at sjohnson@respro.org.

Sincerely,

Sue Johnson, Esq.

Executive Director

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